ENTREPRENEURSHIP IN EGYPT

CASE STUDY: POLICY RECOMMENDATIONS TO REVERSE ESTABLISHMENT OF STARTUPS OUTSIDE EGYPT

AFRICAN DEVELOPMENT BANK GROUP
GROUPE DE LA BANQUE AFRICAINE DE DÉVELOPPEMENT

with funding from

Schweizerische Eidgenossenschaft
Confédération suisse
Confederazione Svizzera
Confederaziun svizra

Swiss Confederation

Federal Department of Economic Affairs, Education and Research EAER
State Secretariat for Economic Affairs SECO

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TABLE OF ACRONYMS AND ABBREVIATIONS

ACE	Accelerator Contract for Equity
ADGM	Abu Dhabi Global Market
AfDB	African Development Bank
ASRT	Academy of Scientific Research and Technology
AUC	American University in Cairo
BVCA	British Venture Capital Association
BVI	British Virgin Islands
CBE	Central Bank of Egypt
CEO	Chief Executive Officer
CFO	Chief Financial Officer
DFI	Development Finance Institutions
EBRD	European Bank for Reconstruction and Development
EPC	Economic Performance Committee
ESOP	Employee Stock/Share Option Plan
FFF	Friend, Family and Fools
FRA	Financial Regulatory Authority
GAFI	General Authority for Investment and Free Zones
IFA	Independent Financial Advisor
IFC	International Finance Corporation
IPO	Initial Public Offering
IPR	Intellectual Property Right
ITIDA	Information Technology Industry Development Agency
JSC	Joint-Stock Company
KISS	Keep It Simple Security
KPI	Key Performance Indicators
LLC	Limited Liability Company
MCIT	Ministry of Communication and Information Technology
MOIC	Ministry of International Cooperation
MPED	Ministry of Planning and Economic Development
MSMEDA	Micro, Small, Medium Enterprises Development Agency
MTI	Ministry of Trade and Industry
MVP	Minimum Viable Product
NASDAQ	National Association of Securities Dealers Automated Quotations
NGO	Non-Governmental Organization
NVCA	National Venture Capital Association
RBF	Revenue-Based Finance
SAAS	Software-As-A-Service
SAFE	Simple Agreement for Future Equity
SAFT	Simple Agreement for Future Tokens

SCL	Startup Corporate Law
SEC	Securities Exchange Commission
SME	Small and Medium-Sized Enterprise
SPAC	Special Purpose Acquisition Company
UAE	United Arab Emirates
USA	United States of America
USPTO	United States Patent and Trademark Office
VC	Venture Capital
WBG	World Bank Group

PREFACE

DR. MARTHA PHIRI,
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As the entrepreneurship ecosystem in Egypt flourishes and expands, continuous changes and reforms are required to maintain and consolidate this growth. The African Development Bank, through a generous contribution from the Swiss State Secretariat for Economic Affairs (SECO), commissioned a study to review the current state of the Egyptian legal and policy framework related to start-ups investments. It compares it with established international best practices with the objective of highlighting elements that may need to be adjusted to ensure continued growth in start-up investments.
While some gaps have been previously highlighted on an ad-hoc basis, no thorough analysis has been reported to date. It is the intention of this report to provide such in-depth analysis, particularly as related to Egypt-founded startups incorporating holding tiers in foreign jurisdictions with the purpose of securing growth funds from potential international and, increasingly, local investors.

We would like to acknowledge Mr Loay El Shawarby, a seasoned legal expert and author of this report for his meticulous review of the legal framework and the recommendations laid out in the report. The content of the report was presented to and vetted by the Entrepreneurship Core Committee of the American Chamber of Commerce in Egypt, for which we owe them thanks. Finally, we look forward to adoption of these recommendations by the relevant Egyptian authorities and would like to acknowledge the commitment to improving the entrepreneurship enabling environment as demonstrated by the newly established unit under the Council of Ministers in charge of reviewing appropriate policies and regulations for start-ups, and headed by Mr Hossam Heiba, President of General Authority for Investment and Free Zones (GAFI). Due appreciation goes to our partners SECO, and in particular Christine Sete, program manager, and Michal Harari and Laila Kennawy, from the Egypt team.

From the side of the Bank, I would like to acknowledge the efforts of the Innovation and Entrepreneurship Lab team, guided by Tapera Muzira, Lead Specialist within the Human Capital Department and Regional Sector Manager for North and Central Africa; Absa Gningue, Innovation Platform Officer; and from the Egypt Country Office, Gehane El Sokkary, Principal Social Sector Expert who were all instrumental in seeing this critical assignment come to fruition.

Martha Phiri
Director, Human Capital, Youth and Skills Sevelopment,
African Development Bank

EXECUTIVE SUMMARY

Entrepreneurs find it natural to start their ventures in their home countries. But as a startup begins to seek more substantial funds for growth, interested angels, domestic or international, may require the startup to establish an offshore holding company to receive the funds and structure the investment deal in a jurisdiction that provides better protections and easier transactions. Home countries of startups are displeased when their startups deploy a holding tier at a foreign jurisdiction. But if the laws and policies of the home country are not able to cater to the growing legal needs of the startup, holding tiers in the friendlier jurisdictions become an absolute necessity.

Entrepreneurial activities in Egypt started to pick up viable momentum over a decade ago. Recognizing the significant potential benefits of this economic channel for the Egyptian economy, the government of Egypt has adopted an encouraging approach towards it. As entrepreneurship is a fairly recent phenomenon in Egypt, the current laws and procedures are in large part silent on issues of concern to startup structuring, and do not confer upon Egyptian startups the investment protections and incentives required to attract international investors. This inevitably has led to incorporation of Egyptian start-ups in foreign jurisdictions. To date, the sporadic attempts of the Egyptian government institutions to prevent Egyptian startups from seeking growth funding in other jurisdictions have not been met with great success, largely because they do not address the multiple issues needing intervention, and partially because they follow a piecemeal approach in adopting solutions. Recently, the government started to realize the magnitude of the challenge of establishing a true startup-friendly legal and policy environment that can match up well with regional and global competitors. Startups founded in Egypt are increasingly establishing holding company tiers in other jurisdictions as a necessary step to obtain growth capital from international investors. This behavior has become more prevalent in recent times as mandated not only by international investors but by their domestic counterparts as well. The Egyptian authorities need to act on this pivotal reality. The provided case studies of Grinta, El-Gameya, and others make this point ever clearer.

The review of law in this report is limited to laws related to structuring startups and attracting investment, without the need to incorporate a holding elsewhere. These laws include the general companies' law no. 159 for the year 1981, the investment law no. 72 for the year 2017, the capital markets law no. 95 for the year 1992, and the MSME law no. 152 for the year 2020.

The structure of the report follows a methodical approach: Chapter one gives an introduction on the study and its objectives; chapter two presents the Egyptian start-ups ecosystem with a focus on of the main activities and players in the entrepreneurial ecosystem in Egypt over the past 15 years or so and includes some case studies; chapter three provides insights on elements of start-up friendly jurisdictions presenting famed tensions in the startup investment model that have been observed over the years and the international Best Practices developed to address those tensions; chapter four maps out some of the main tensions in start-up investing and their associated best practices within the context of the current Egyptian legal and policy framework. Upon presenting the size and nature of this gap, in chapter five, the report concludes with providing several recommendations that can help guide the Egyptian government undergoing efforts to become a competitive jurisdiction for startups founded under its laws and throughout their lifecycle.

The report provides recommendations to assist the government of Egypt focus its efforts in this domain. These recommendations were discussed and vetted with several groups of ecosystem actors, including at a meeting of the AmCham Entrepreneurship Core Committee , and formally and informally with the Egyptian angels communities, namely, Alex Angels and AUC Angels, and representatives of the venture capital community and representatives of startup founders, as in the case studies section. There is a need for the relevant authorities, namely (GAFI) and the Financial Regulatory Authority (FRA) to conduct an immediate and thorough review process aiming to produce (i) a matrix of the legality of the various concepts perused in startup investing; and (ii) a matrix of the related legal rules in the law and the constitutional company document templates distinguishing those that are mandatory from those that are supplementary. This critical distinction shall provide latitude or restraint for parties in complimenting official templates with contractual agreements optimized for their individual circumstances. Additionally, and where the current laws are not accommodating to the globally perused legal concepts and best practices, there is a need to devise a legislative proposal for a simplified holding company form simulating the holding tiers Egyptian startups opt for in the startup friendly jurisdictions, as detailed in the recommendations section of the report. A steering committee of ecosystem practitioners could support and review these initiatives to bring Egyptian law and policy in line with international best practices.

[1] Meeting of the Entrepreneurship Core Committee held at the AmCham premises in Cairo, on April 19, 2023. Participants at the meeting included Mr Hossam Heiba, President of GAFI, who was a keynote speaker, as well as AmCham members from the ecosystem.

CHAPTER 1

INTRODUCTION

1.1 The Challenge

Since entrepreneurship has become a global phenomenon in the past two decades, countries have realized the need to develop attractive legal and policy frameworks that can enable local entrepreneurs to build startups of global clout. Much of this attractiveness is related to providing comfort and confidence to lure potential investors, particularly during growth. The efforts of different countries in this regard have been met with various degrees of success. Due to this varied success, it is common to see startups operating in their home countries to leverage savings in operational cost while establishing holding tiers in foreign jurisdictions where regulatory and legal factors are more appealing to investors providing growth funds.

Over the past 10 years, the entrepreneurial ecosystem in Egypt has gathered good momentum. The Egyptian government, recognizing the substantial benefit that successful startups could bring to Egypt's economy, adopted an attitude of encouragement. But while Egypt is trying to ensure a healthy ecosystem for Egyptian startups as would be available in other startup-friendly jurisdictions, there remains gaps in the legal policy framework to be addressed in order to convince investors that its corporate law, contract law, and laws relating to startup investing are adequate, consistent, and enforceable. A clear and competitive policy framework with respect to startups establishment and governance needs to be developed, implemented, and communicated. Such competitive legal and policy framework is especially critical for Egyptian startups to remain incorporated in Egypt as they start seeking growth funds; potentially refraining from forming holding tiers in other jurisdictions. Earlier attempts by the Egyptian government to address this issue have been mostly sporadic and followed a piecemeal approach in adopting solutions.

The main concern of this study is with the laws and policies in Egypt relating to startup-founder-investor structuring, which is the core issue driving startups to incorporate a holding company tier in jurisdictions reputed for being startup friendly. The study did not concern itself with numerous other laws, rules, and regulations that impact the day-to-day functioning of the operating entity. These issues are not addressed here as they are operational in nature and are faced by all businesses operating in Egypt. Finally, it has been presumed that the operating entity of the startup is based in Egypt. The report makes a clear distinction between startups with high growth potential (and global ambitions) and SMEs adopting traditional business models (and largely remaining local players). The latter case is completely outside the target scope of this study.

1.2 Investment Issues

The relationship between startup founders and investors is quite peculiar, as it differs in large measure from conventional businesses and traditional investing. The typical model for this relationship is simple: founders contribute ideas, time, and effort, while investors mostly contribute cash and connections. At the core of such model lie startup-founder-investor tensions that different startup ecosystems strive to accommodate if they should become competitive for both entrepreneurs and investors. These tensions shall be discussed in detail later and mapped to the case of Egypt.

Regardless of their nationality, entrepreneurs' ambitions to engage with investors and startup investors' appetite to invest in this high-risk asset class have been calibrated over years of actual investing. The uniqueness of startup investment vehicles dictates the terms of its structuring, funding, and governance. The startup business model aims to achieve rapid scale-up, and typically requires substantial funding to succeed. Because each startup model is unique and mostly untested, the success of the model remains uncertain, and thus traditional funding sources such as commercial banks would refuse to become involved in such high-risk ventures. Startup funding, therefore, devolves upon a niche class of investors, mostly business angels and venture capitalists, who agree to invest where other financiers hesitate. Startup investors and investees have developed their own investment strategies and tactics, in which they rely heavily on a mix of corporate law of the state in which the startup is established, as well as its contract law. Both laws[2], corporate and contract, need to be flexible and permissive to allow for latitude in investor-investee structuring, in addition to being enforceable to uphold the terms agreed to.

1.3 Legal Issues

A dependable legal framework is the cornerstone of a thriving startup ecosystem, as it offers aspiring entrepreneurs a reliable set of regulations that govern the creation, funding, operation, and exit of their ventures. For a startup ecosystem to attract investors willing to back startups based in that particular region, it must have legal policies that are adequate, consistent, and enforceable. Achieving these objectives is essential for any country that seeks to compete in the global entrepreneurship arena.

Throughout this report, the legal rules and instruments afforded to startups and their investors as norms in the ecosystems gaining international prominence shall be elaborated and matched to the startup investment model. They shall then be contrasted to what Egypt

[2] Other laws may have relevance, but those two are overarching.

affords. The process shall highlight current legal and policy deficits in Egypt that drive founders and investors to add a holding tier to Egyptian startups in other jurisdictions to qualify for larger investments. This phenomenon is generally linked to international investors, but increasingly to Egyptian investors as well.

1.4 The African Development Bank Initiative

In order to assist Egypt in planning a course of action to support startups to incorporate and remain incorporated in Egypt at growth, many international organizations, mostly Development Finance Institutions (DFIs), have offered support through commissioning studies, such as this, to aid in understanding the various facets of the startup phenomenon that could help it prosper in Egypt, including learning from other countries' experiences, benchmarking with best practices, thinking of practical solutions to suit Egypt's culture, and developing Egypt's business and investment competitiveness. Prominent among such DFIs are the African Development Bank (AfDB); the European Bank for Reconstruction and Development (EBRD); and the World Bank Group (WBG), especially its International Finance Corporation (IFC).

The Egyptian government aims to curb Egyptian startups trending practice of incorporating a holding tier for their business in foreign jurisdictions deemed more startup friendly. To counter the practice, the authorities wish to offer a national alternative which is convincing to entrepreneurs and their investors, local and international. Popular address in Egypt of the topic confuses the issues involved. Whereas investors are looking for specific protections to become comfortable to invest directly through an Egypt entity, popular thinking in Egypt mixes up the required protections with the ease of operating the day to day business. This confusion is more troubling when it becomes the sole adopted agenda by officials, distracting them from addressing the real issues head on. Easing of day-to-day operations is no doubt needed, but that is besides the issue when discussing investment structuring. The startup-founder-investor structuring relationship is what needs to be addressed. At the heart of these dynamics is the fact that corporate and contract laws need to combine to provide comfort for the parties to transact, and that their deal terms should be guided by international best practices. Such best practices have evolved from years of actual investing and therefore are attuned to various needs of the parties involved. One of the main goals of this study is to help unpack this entanglement.

1.5 Structure of the Report

The remainder of this report is organized as follows.

Chapter two provides a narrative of the Egypt startup story. Although it has started less than two decades ago, over those years, most of the actors required to put together a healthy ecosystem have evolved. This includes entrepreneurs, incubators, accelerators of government, private, and universities, angel investing networks, and VC funds. The number of investment deals achieved are impressive and outweigh the number of deals made in any other country in the Arab World and Africa. Most of the investment deals, however, were structured at a level of a holding tier outside of Egypt, revealing a dire gap in the legal and policy frameworks in Egypt.

Chapter three starts by identifying the tensions and risks associated with the startup investment model, namely that the investors receive minority shares in the business. By acquiring only minority shares, the investors could become subject of entrepreneurial opportunism in so many ways. The entrepreneurs could threaten to leave management of the startup, to sell the start up short, or to change the purpose of the startup, to the detriment of the investors. The fact that corporate law follows a one share one vote rule, generally, means that standard governance could disadvantage investors. To mitigate such risks, the discussion in this chapter will shift to present unique mixes of corporate and contract laws that had evolved in the form of best practices. These best practices are centered on balancing the bargains of cash flows and control rights involved in each deal.
Chapter four discusses the Egypt case in light of the best practices sought by international, and increasingly local, investors. Egypt shows a significant deficit in regards to adoption of best practices, particularly relating to: (i) constitutional company documents, and the protections typically afforded thereunder, e.g. share vesting, non-voting shares, among others; (ii) valuation, and how it differs in the case of startups from established corporates; (iii) innovative financing instruments, including convertible notes and the prevalent SAFE and KISS variants, and the RBF; and (iv) the shareholders agreement, what it includes, and how it relates to the state sanctioned constitutional company documents, in particular to mandatory and complimentary rules. Overall, the chapter highlights the missing links between the best practices needed to deliver Egypt's hopes to become startup investor friendly and the realities that face founders and investor reinforcing the trend of establishing a holding tier elsewhere.

Chapter five concludes with recommendations.

1.6 Excluded Issues

Before moving forward it is important to emphasize that the success of startups would also relate to the laws of the respective domain in which the startup operates or other general laws impacting the market. Some areas of activity, for example, are heavy on technology while others may be based on brick and mortar. Some startups may be subject to elaborate regulatory regimes requiring licensing or approvals, e.g., Fintech, big data, robotics, drones, and biotech. The process of acquiring licenses or approvals and maintaining them could be technically complex and costly. In some instances, new activities might be in need for a regulatory sandbox. Other startups may be subject to light regulatory regimes or none at all. Other market laws of impact could also decide the fate of a startup, competition, bankruptcy, employment, social insurance, taxation, are examples of such laws, among numerous others.

All excluded issues referenced in the foregoing paragraph relate to day-to-day functioning and do not speak to the main question of this study, namely of laws and policy in Egypt relating to startup-founder-investor structuring, the main reason driving the trend to incorporate a holding company tier in other startup friendly jurisdictions.

CHAPTER 2

THE EGYPT STARTUP NARRATIVE

2 The Egypt Startup Narrative

2.1.1 General

The story of startup investing in Egypt dates back roughly to just over a decade and is growing fast as is the case in many other countries. Since the process by which a startup begins, gathers momentum, and grows differs drastically from that of conventional businesses, startups find it difficult to operate through conventional corporate forms. Broadly, technology enabled startups carry more promise to grow than conventional businesses. This is why it is important to distinguish the genre of startups aiming at super growth with innovative business models from those businesses replicating standard business models. Mixing both types together is not considered optimal for the success of either model, and this is a feature of Egyptian policy and laws to date as demonstrated by the lumping of start-ups with SMEs in . Egyptian Law no 152 of the Year 2020.[3]

2.1.2 Before the 2011 Revolution: Entrepreneurship from the Fringes to Center Stage

Entrepreneurship and startups are currently understood and appreciated by the various players of the Egyptian ecosystem and the Egyptian state, unlike the initial batches of entrepreneurs that came before 2011. Although the earlier batches of entrepreneurs were of true entrepreneurial mantle and came with solid domain expertise and relevant track record in their startup fields, the 'entrepreneur' brand had not yet earned societal recognition. They still delivered decent companies that became healthy local businesses going into partnerships with, or were acquired by, global players. And, of course, many of them failed. Examples of these early entrepreneurs are Dr. Khaled Ismail's SysDSoft, Eng. Wael Amin's ITWorx, Khaled and Karim Beshara's Link.net, Dr. Ahmed Morsy's Nebras Technology, Eng. Mohamad Shoura and Houssam Rady's MillenTech, Ayman Rashed's Otlob, and Ahmed Zahran's Karm Solar, among others.

Entrepreneurship and startups in Egypt went through waves of evolution as they moved from the fringes of attention to center stage after 2011. Awareness of entrepreneurship and startups in Egypt was not easy to achieve and came piecemeal. It was first promoted by a few enthusiasts, international corporates, and NGOs. Thereafter, it slowly became mainstream with a place not only for general entrepreneurship but also for specialty entrepreneurship areas, such as social entrepreneurship, and verticals within a certain area, such as fin-tech, health-tech, and Ed-tech. The lines between and amongst areas and verticals of entrepreneurship may cross over or overlap. Examples of individuals and organization who promoted entrepreneurship included:

- Mr. Ahmed Alfi, who founded Flat6Labs, the Greek Campus, and Sawari Ventures.
- Eng. Hanan Abd Elmeguid, who earlier founded the Camelizer investment company, and, recently, the reputed co-working space – Consoleya.
- Google with its widely acclaimed 'Start with Google' competition.
- Nahdet El-Mahrousa NGO with its Yahoo-Maktoob! Partnership competition 'Social Innovation Starts with You - (SISWY)'.

Numerous other individuals, corporates, and NGOs followed - (see Appendix 2 on the Egypt Entrepreneurship Map – 2022, produced by Egypt Innovate and updated periodically). For a more extensive review of all Egypt entrepreneurship ecosystem and their affiliation classification, as universities, government, companies, or NGOs, we refer to the AfDB study titled "Entrepreneurship in Egypt: 2022 Ecosystem Overview" authored by Dr. Ayman Ismail.

Competitions grew to become commonplace. Some competitions went beyond awareness and promoted set-up of startup businesses from among the participating teams. The target entrepreneurs' pool for awareness and startup founding teams was Egyptian youth, whether at university, recent graduates, or older. Many pains were obvious in most corners of Egypt's society and economy, and entrepreneurship was being promoted as a route to find solutions to those pains.

2.1.3 The Momentum Phase: 2011 Onwards

Alongside, or perhaps a bit later to competitions, the set-up of incubators and accelerators started shy and then proliferated throughout the country, with Cairo being the first city. Competitions, incubators and accelerators mobilized multiple resources to deliver their programs to intended audiences. Resource mobilization included securing the financial, human, and organizational capacities needed to implement the various programs and incubation and acceleration cycles as they recurred. Leveraging the resources of other organizations sharing the same cause and connecting to the wider interested communities to act as sponsors was often pursued. Corporates, banks, international organizations, development finance institutions represented a clear sample of potential

[3] While Entrepreneurship is not by default the definitional term for startups, it is however the term used for the various activities that the startups naturally engage in. In part one "Definitions" of the relevant law on SMEs, the term startup is not defined, however, the term "Entrepreneurial Projects" is (مشروعات ريادة اعمال). The definition clearly states that any project that "include(s) a degree of novelty or innovation" is an entrepreneurial project. Which is extremely similar to the startup definition, only lacking two distinctive characteristics in its definition: (i) the high-risk high-return characteristic and its scale-up; and (ii) the need for constant cash injection for startup growth. Nonetheless, given that there are no laws that define the notion of startup, this similarity is used to regulate this adverse entity.

funders. Some incubators and accelerators also provided incubation or acceleration grant money to startups, and securing such grant money represented an additional challenge. The ratio between those incubators and accelerators that provided funds to their target startups is not apparent. Incubators and accelerators which were formed for public cause would not usually take equity in the startups they support. Private incubators and accelerators would invariably take equity, although they still needed to figure out the percentage of equity to take and how much to pay for, and whether their in-kind support services would represent part of the deal.

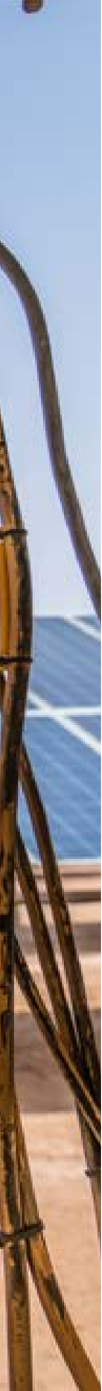
Examples of incubators and accelerators of the time include Flat6Labs, the AUC Venture Lab, Innoventures, and a few others. A few years later, more incubators and accelerators formed, some of them were affiliated with private businesses, private and public universities, and government institutions. The more astute and clever incubators and accelerators survived and made fame to this day, although profits from the incubator and accelerator models continue to be questionable. Indeed, the story of incubators and accelerators was one of boom, bust, and survival.

2.1.4 Enter the Government

The first incubators and accelerators of government were attached to the Ministry of Communications and Information Technology (MCIT), particularly the Technology, Innovation, and Entrepreneurship Center (TIEC), and the Ministry of Trade and Industry (MoTI). Later, the Academy for Scientific Research and Technology (ASRT) took a renewed interest in science entrepreneurship. They created multiple programs of awareness as well as incubators and accelerators catering to its partial mandate of increasing commercialization of science. Soon after, the Ministry of Investment and International Cooperation (MoIIC, which had, for a short period, become a merge between the Ministry of Investment and the Ministry of International Cooperation), and the Ministry of Planning and Economic Development (MoPED) joined the fray and staged awareness programs, incubators, and accelerators in support of entrepreneurship.

The intervention of the MoIIC has been the more notable among those undertaken by the government. The intervention included MoIIC's setting up of two entities that worked in tandem: the "Falak startup accelerator" and the "Egypt Ventures" investment company. Falak organized accelerator cycles that were coupled with initial investment. Egypt Ventures provided larger early growth capital to some graduates of Falak and startups of the ecosystem at large. What we consider as notable here is Falak and Egypt Ventures found themselves entangled with the same 'prohibitive' laws and regulations that many private players of the ecosystem complained of.

Falak and Egypt Ventures tried to figure out solutions, counting in part on their governmental sponsor – MoIIC. They articulated and relayed the difficulties to the government, as they experienced them firsthand. As the General Authority for Free Zones and



investment (GAFI)- the entity largely responsible for company formation in Egypt- fell under the oversight of MoIIC, legal changes and responsive circulars were readily issued to respond positively to the needs of the ecosystem. However, most efforts towards change lacked sufficient guidance, as no comprehensive studies were commissioned to understand what was needed in terms of change; and how change may be affected from within existing legal structures. Most calls for change were sporadic and came from practitioners rather than lawyers. While those practitioners were close to the startup scene and had a good grasp of the core issues, they were not specifically versed in legal intricacies to articulate them properly.

2.1.5 Incubator/Accelerator Hopping

With the above momentum in place, and in line with the nature of entrepreneurship and startups, entrepreneurs founding their real-world startup beyond competitions and incubators/accelerators were now seeking funding. The ones that underwent incubation or acceleration were now better equipped with knowledge of the startup investment space and, hence, they stood better chances at getting desired funding. In the aggregate, they were at a more advantageous position in terms of pitching their ideas, developing business models, building products, and clarifying and quantifying their revenue streams and growth prospects. Such were, and remain, good skills that are typically acquired while joining an incubator or accelerator. Additionally, incubators/accelerators provide mentorship and networking to their startups. Some startups, however, pursued more than one incubator or accelerator in parallel or in sequence. Incubator/accelerator hopping on the part of entrepreneurs was questioned, with most angels disapproving of the practice. These angels frowned upon entrepreneurs perceived to be hiding or unwilling to meet the real business world. One incubation or acceleration cycle was deemed enough, but two were deemed futile. Entrepreneurs, in their own defense, explained that they pursued such practice because it provided more cash to fuel their startups. They were also especially encouraged to do that in the cases where the respective incubator or accelerator gave seed funding, however small, but did not take equity. As for why incubators/accelerators would permit such a practice, the reason may be related to the limited flow of quality applicants. This inadequate flow reflects scarcity of quality entrepreneurs in the ecosystem. More importantly, it reflects the shortage of scouting efforts aimed at discovering budding entrepreneurs and encouraging those who are still hesitant to go through the entrepreneurial experience. One initiative worth mentioning here related to scouting efforts is ‘Fekretak Sherketak’ (your idea, your startup) which was organized by Egypt Ventures and involved a bus campaign that toured Egypt searching for entrepreneurs and building a much-needed awareness.

2.1.6 Angels and angel networks

Beyond personal, family, and friends funding, startup investing was by and large confined to a handful of incubators and accelerators in Egypt. Both were limited in the amount of offered funds, even though they have carried significant weight in building momentum. Angels were the next step in the startup investing ecosystem, responding to the rising funding needs of startups as more and more startups demonstrated growth potential. The token investment funds provided by competitions, incubators and accelerators were deemed insufficient to pull the startup off the ground. A streak of angel investor networks was formed: the Cairo Angels in 2012, by Hossam Allam; the Alex Angels in 2017, by Tarek El-Kady and Loay Y. El-Shawarby; HIMAngel in 2017, by Dr. Khaled Ismail; the AUC Angels in 2017, by Dr. Ayman Ismail. It is to be noted that Cairo Angels, Alex Angels, and HIMAngel, were formed as private companies, while the AUC Angels as a university network. These remain the major angel networks in Egypt to date. In 2016, Malaika was formed by Eng. Samir Alaily as an umbrella organization – a network of networks – with a mandate to spread more awareness and broadly coordinate angels investing efforts in Egypt.

2.2 Case Studies

All the upbeat narrative about Egyptian startups, especially those that are technology enabled, becoming a force for revitalizing, digitizing, and transforming the Egyptian economy, would not be complete without a debrief of how most of them faired at their actual fundraising efforts. This is the core question in the current study, aiming to provide recommendations to the Egyptian government to avoid incorporation of holding tiers to Egyptian startups to qualify for investors funds. Three case studies will be presented to put the matter into perspective. Two of the three, Grinta and Gameya, were willing to have their actual stories and names shared. The third preferred anonymity. Additionally, the managing director of Endeavor, Mr. Amr Elabd was interviewed. The Endeavor network hails from New York and has more than 40 chapters worldwide. Finally, two major international VC funds investing in Egypt were interviewed. The two VC partners preferred to stay anonymous, including their fund names. For the company that decided to remain anonymous, I gave the name The Every Cool Person Platform Company, and for the funds, the Love Egypt Fund and the Love Africa Fund.

2.2.1 Grinta:

Grinta is a company that was started in 2021 by Mohamed Azab and three co-founders with immense entrepreneurial experience in Egypt and the USA. Grinta is a B2B marketplace in the medicines space. It connects manufacturers to wholesalers and retailers. Grinta capitalizes on technology and data analytics to challenge legacy distributors. It offers modules

aimed at providing transparency and traceability of the products and their sales. The size of the Egypt market is estimated at around USD 6 billion, and the African market at roughly USD 50 billion. Grinta is now heavy on Egypt but plans to pan out as an Africa player. Mr. Azab has been a serial entrepreneur in the health tech space for the past 12 years. Previously, he grew Hassab medical testing labs from 6 branches in 2012 to more than 70 by 2017. He started another venture in 2016, acquiring small hospitals with small number of beds and consolidating operations to achieve unit cost efficiencies. Mr. Azab studied finance as an undergraduate in Seattle, Washington, and 15 years later received an MBA from Harvard.

When asked about whether he needed to incorporate a holding tier outside of Egypt to receive the famed USD 8 million, the founder of Grinta replied that as a seasoned entrepreneur and (sometimes) angel investor, he did not wait for the big round to incorporate a holding in a startup friendly jurisdiction: he did that from the start. The reasons given were manifold, appealing to prestigious investors of global repute as Grinta did when it recruited California based Endeavor Catalyst Fund, 500 Global, and Saudi Raed Ventures. Such a structure helped him issue convertible notes for small funds at initiation of the business. The more advanced the stage of the fundraising (debt or equity) the more handy the structure proved to be. According to Mr Azab, investors look for many rights that are not always afforded under Egyptian laws, as well as for certainty and enforceability of their agreements and their deal terms. They want no surprises. As an entrepreneur, he felt duty-bound to respond positively to these investors wishes. He would not argue with them and risk losing the investment. Mr Azab also mentioned that most times the funds are raised to cover Egypt and other markets, and as much as he loves Egypt, it would not be wise to receive the funds earmarked for other markets in Egypt, as transferring such funds out might not be possible at a down-cycle in Egypt. To him, Egypt does not lose investment funds when a holding is setup in a foreign jurisdiction, as the fund earmarked for the Egypt market would always channel into Egypt to operate the subsidiary and grow locally. Additionally, he stated that investors do not particularly look for incentives as much as they look for protections. Finally, Mr Azab believes that approaching African markets at expansion would carry more weight as a foreign venture than as an Egyptian company (a brand issue). To his mind, Egypt need not to worry about incorporation of holdings in other startup friendly jurisdictions. Egypt should rather take care of the local business environment to smooth market operations.

2.2.2 El-Gameya:

El-Gameya was started in 2018 by Eng. Ahmed Abd El-Baky. It digitalizes the 'Gameya' saving model in Egypt (the local version of a ROSCA). The total addressable market is USD 350 billion globally, while the Egyptian market stands roughly at USD 7 billion. Fourteen million Egyptians already participate in this model annually. Typically, gameya participants know and trust each other through extensive social networks, with recruiters of a particular gameya cycle acting as gatekeepers and many times guarantors of each participant. Social pressure was effective and enforceable to avoid situations of opportunism or defection. Social naming and shaming provided sufficient mitigation in most cases. These days, many gameya participants do not know each other, with each focusing on their urgent needs but not on others, making it unpleasant for fellow participants and gatekeepers to maintain a seamless collection process. Ahmed recognized the gap and thought to close it with a digitalization product that eases recruitment in terms of forming a gameya cycle, and equally important, by running a digital know your client (KYC) on participants to ensure their good standing and close trust issues. El-Gameya also guarantees each cycle on the platform. To date, El-Gameya closed numerous deals with schools, corporates, and others, encouraging their employees who traditionally did gameyas together to take their gameyas online, and benefit from the seamless processes instituted by El-Gamyea company. El-Gameya further negotiates substantial discounts from retailers that it is willing to pass onwards to participants at cashing out their saving positions. Many participants save to buy marriage items (e.g., white goods), to go on holidays, etc.

Ahmed has repeatedly fundraised for El-Gameya - both equity and debt. The initial angels gave humble but much needed funding (to the tune of USD 40 K) and entered into the company cap table, suffering from the valuation related issues mentioned in the Egypt case (Chapter 4). Because the early investors were Egyptians who liked both the entrepreneur and the startup idea, they decided to take the risk and remained supportive throughout. When El-Gameya needed some USD 200 K in late 2019, Ahmed managed to recruit an equally enthusiastic group of angels. Although they believed in him and the startup potential and trusted the earlier investors vouching and experience with the startup, they still needed a more straightforward structuring without the perceived open-ended risks assumed by the earliest angels. The solution was a shareholders agreement with conditions subsequent to incorporate a holding structure within a specified time period, and to sell the Egyptian operating startup fully to the holding. Another subsequent condition was to execute the terms of the shareholders agreement at the level of the holding. Other early growth funds joined the pre-seed round with checks of USD 100 K or less each. Those early-stage funds would not transfer money until the holding company had been incorporated and issued convertible notes for the debt investments agreed. The funding came in just in time to keep the subsidiary operating. A later seed round was opened and is still in progress. This time the investors included large Egyptian investment companies and corporates, with the lead investor's funds directly coming from the Egyptian government. The lead investor and the other corporates joining insisted on an extensive shareholders agreement at a startup friendly jurisdiction to avoid confusion about effectiveness of the deal terms and their enforceability. Luckily to Ahmed and El-Gameya, the jurisdiction chosen at the previous angels' round – the Netherlands – was acceptable to the series seed investors.

2.2.3 ABC Company – (Prefers Anonymity)

A company that constructed an interesting platform serving a decent size segment of the population, any population around the world. Such population is youthful, ambitious, and with cool ideas. The business model centers around the platform and white labels of it. It started in Egypt and soon after brought in a few clients from the Middle East, Europe, Asia, North and South America, and Africa. Specific countries where the platform had conducted business are: KSA, UAE, Iraq, Tunisia, Germany, the UK, Belgium, Australia, the USA, Mexico, and Senegal. At receiving international accelerator funding, the company was requested to incorporate a holding tier for the business. Three countries were specifically suggested, Cayman, the USA – Delaware, or the Abu Dhabi Global Markets (ADGM), with Cayman being the strong recommendation. The company incorporated a Cayman holding. The entrepreneur stated that Egyptian angels as well would not invest directly in an Egyptian entity. No particular legal insights were given by the entrepreneur. To the entrepreneur's mind, the incorporation of a foreign holding company tier was a given, as happening with all other startups coming out of Egypt and the region.

As a digression from the issue of incorporation in a foreign jurisdiction for receipt of international funding, another issue applied to ABC. With the diversification of markets from which the company drew its revenues, using a reliable payment gateway became an eminent need. By mid-2020, upon the devaluation, payment gateways in Egypt converted revenues received in hard currency into Egyptian pounds at payment. The hard-earned foreign currency of the company was forfeited without company's choice, even when the company may need such hard currency to settle its own international expenditures. The company was advised to open a Delaware operating entity with a bank account to take care of international sales. It is to be noted that the newly incorporated Delaware entity served as an operating entity this time rather than a holding as is usually the case.

The company's global footprint is expanding, and comparing Egypt to other countries at ease of doing business and operation, e.g., KSA and UAE, the entrepreneur is worried it might make more sense

to reincorporate the business in another jurisdiction, including operations. The entrepreneur thought that social insurance treatment, tax treatment, limited digitalization, and lack of electronic signature, took a toll on the ease of doing business. If the company decides to fully reincorporate elsewhere, it would continue to serve the Egypt market from its new base.

2.2.4 Interview: Endeavor Egypt CEO – Mr. Amr Elabd

Endeavor is an international organization headquartered in NY. The organization supports the growth prospects of startups of established traction and demonstrable market potential. They do not invest as a network, although they put together the Endeavor Catalyst Fund to invest in Endeavor network startups around the world.

Mr. Amr Elabd, the CEO of Endeavor Egypt, who in a previous life served as managing director of the Egypt Ventures investment company, is of the view that investors requiring Egyptian startups to incorporate a holding company tier in a startup (and investor) friendly jurisdiction to qualify for investors funds, do that to (i) ease investing through innovative financial instruments, like the convertible notes variety, whose availability is disputed (and therefore uncertain) under Egyptian law; (ii) efficiency and timeliness of judicial process; (iii) benefiting from neutrality of capital gains taxes; (iv) ease of repatriation of funds, especially where the funding serves multiple markets; (v) avoiding complications in valuation determination at capital increases; and (vi) receiving investors (minority rights) protections.

2.2.5 The XYZ Fund – (Prefers Anonymity)

The EGXYZ fund is incorporated at an offshore jurisdiction, with a mandate to invest globally in early-stage technology-enabled startups. A few of the fund's venture partners focus on Egypt and the region. The investment ticket ranges between USD 750 K and USD 2 million.

The interviewed VC partner from XYZ confirmed that Egypt has good startups. Over the last two years, the fund invested some USD 10 million and an additional USD 5 million is underway. The fund has appetite to make more investments in Egyptian startups. But he gave many reasons for why they require potential portfolio startups to incorporate a holding tier at a startup-and-fund-friendly jurisdiction. First, legal certainty, including issues related to founder's vesting, use of convertibles, capital increase valuations, investors rights and shareholders agreements, and other judiciary factors - clarity of law, procedures, and timelines. Second, tax issues, with respect to corporate income tax and capital gains. Third, macro-economic risk factors, chief among which is free flow and repatriation of capital and forex stability; an example of which is ease of settling of international expenditures, as startups often use international service providers or talents to fill gaps. Fourth, board considerations. Investors avoid sitting on boards of companies in Egypt as liability may attach to them in ways they do not fully understand. It is not clear whether indemnification of board directors is supported explicitly by Egyptian laws. Moreover, even if insurance of board directors is available in Egypt, it is not commonplace.

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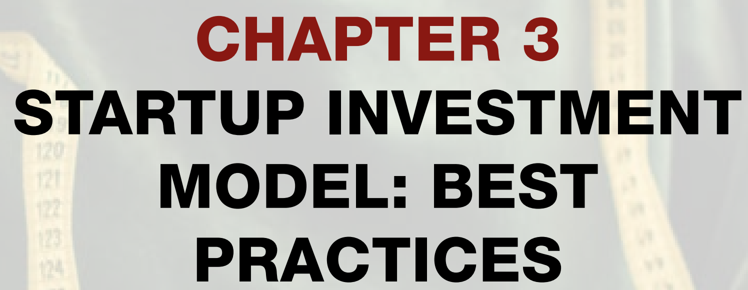
The QRS fund is incorporated at an offshore jurisdiction, with a mandate to invest in African growth-stage startups. The investment ticket ranges between USD 5 million and USD 15 million per startup, targeting 20% or less of the funding round.

The VC partner who scouts and invests in Egypt remarked that Egypt has great startups capable of transforming local and regional markets. The fund has invested in few opportunities to date and they look forward to investing in more. Adamantly, the fund requires each of its portfolio companies to incorporate a holding tier in a startup and investor friendly jurisdiction as a condition for consummating the investment. The fund perceives direct investment into an Egyptian target to be problematic. The notarization and legalization processes associated with producing the investment documents are expensive, take a long time, and are often unclear. The respective notary public, department of state, and Egyptian consulate, need all be engaged, in addition to confirmation at the ministry of foreign affairs in Egypt upon arrival of the documents. Mauritius, as an example of a startup and investor friendly jurisdiction requires a know your client (KYC) only. The Egyptian KYC has a security clearance component that takes time to procure and is repeated at any amendment of company constitutional documents. Tax treatment is another issue for investors, who are used to minimal challenges by tax authorities at tax filing. An audited tax report is sufficient in a startup and investor-friendly jurisdiction; unlike in Egypt where tax assessors often make arbitrary claims to taxes and require excessive advance tax payments - on account – until settlement is later made. Capital gains taxes imposed in Egypt may put investors invested into Egyptian local entities at a disadvantage with other investors participating in entities incorporated in tax neutral jurisdictions. The elephant in the room that the VC partner mentions is repatriation, as Egypt frequently witnesses forex crunches. Paying for a legal consultant in Holland out of a company bank account in Egypt meant a few months of wait, when the invoice was straightforward, and company dollars were available.



CHAPTER 3
STARTUP INVESTMENT MODEL: BEST PRACTICES

3 Introduction

This chapter lays the foundation for understanding the intricacies of startup investing. It puts in focus the different perspectives, expectations, and power dynamics among startup founders and investors that permeate various stages of startup growth. This foundation shall come in handy when these concepts are applied to the case of Egypt in the next chapter. The chapter begins with defining the elements that comprise a startup friendly jurisdiction and discusses the impact of these elements on the overall appeal of a particular jurisdiction to investors. Various issues related to structuring startup investment deals are discussed next. At the center of these issues are numerous tensions inherent in the startup investment model, multiple risks typically associated with investing in startups, and best practices that can help address these tensions and mitigate such risks. The chapter ends with key factors enabling successful adoption of the discussed best practices.

This chapter, however, is not concerned with the legal hurdles that face operating startups as they conduct business in their respective markets. It rather focuses on the holding layer that most startups incorporate at a startup friendly jurisdiction where the country of the startup is found to be lacking.

3.2 What Defines a Startup-Friendly Jurisdiction?

Jurisdictions reputed as startup-friendly deploy an adequate mix of corporate and contract laws. Whereas the law is the prerogative of the state, private ordering by way of contracts remains the domain of private parties. Corporate law is comprised of both mandatory and supplementary rules. Constitutional company documents are based on the law. Depending on the legal system in a given jurisdiction and company forms afforded thereunder, the company documents typically include a company contract, statutes, and bylaws. Aside from pure letter law stipulations, the remainder of documents are essentially contractual. That said, because constitutional company documents enjoy the endorsement of the state, state authorities entrusted with the issuance of the model templates exercise much discretion in writing them. Apart from rules of mandatory purport, the choice of the authority of a complimentary rule gives it default clause status. By law, parties cannot agree against a mandatory rule; but they might opt out of a default rule if policy allows. The clarity about each article, clause, or stipulation in the law and model templates, and whether it represents a mandatory or a complimentary rule is of paramount importance. It helps parties and their lawyers make choices that would not later be invalidated. The model templates may therefore be more permissive or restrictive in terms of being capable of amendment and restatement, for accommodating startup-founder-investor structuring needs.

If the law and the constitutional company document templates are clear and conducive to startup structuring, both founders and investors might not need to set up a holding tier at another startup friendly jurisdiction to consummate their deal[4].

Where clear and conducive corporate law and model templates are not sufficient by themselves to deliver the needed structuring comfort and deal terms, an ancillary route might be available; pursuing independent contractual arrangements by way of a shareholders and associated bundle agreements, to complement the law and the model templates[5]. (When Laws Become Too Complex: A Review into the Core of Complex Legislation – Richard Heaton). Contract is the law of its parties, as the adage goes. The shareholders agreement is arguably the more important contract in the world of startup investing. A shareholders agreement entered into while investing regulates the affairs of the startup going forward and sets the terms of the investment and parties expectations and protections[6]. (The Separation of Voting and Control: The Role of Contract in Corporate Governance – Gabriel Rauterberg). A main difference between formal constitutional company documents and shareholders agreements is that standing on their own, the constitutional company documents are enforceable among their parties and against any third

[4] Further developing this point, the author explains that the use of private ordering – namely by drafting shareholder's agreements – as a governance tool is what might be called "Stealth Governance". Specifically, since the agreements made by and between founders and investors are to expand and articulate more clearly and in a customizable fashion the various governance and control prerogatives over the company. Since corporate law and its ancillaries (by-laws and other constitutional company documents) do not address these matters adequately in the startup ecosystem – at the very least, most jurisdictional law does not take into account how startups differ from other types of corporations. Thus, most startup constituents rely on private orderings to circumvent and bypass the limitations of jurisdictional law, and create the necessary governance tools needed, in order to prevent any opportunistic behavior that might arise from founder and/or investor at the detriment of the company's growth and success. Stealth Governance: Shareholder Agreements and Private Ordering – Jill E. Fisch).

[5] While laws are necessary to creating a blossoming ecosystem, it may prove wiser sometimes to lessen legislation and leave more room to contractual freedom. Addressed extensively in this article is the problem inherent to complex legislation, offering a clear explanation of how more often than not, legislation when taken to the extreme, becomes more restrictive and constrains the activity it tries to organize. While creating a legal framework is a good idea, providing contractual latitude around said legal framework equally important, since the players in every ecosystem are more cognizant to the limitations of their own field of activity.

[6] It is stated that "Shareholder agreements – contracts among the owners of a firm and sometimes the firm itself – are known to be a central instrument of corporate law and at the core of private company governance". As such, in the startup ecosystem, private ordering is seen as a mandatory pre-requisite to healthy startup growth. While laws do contribute by creating a legal framework that defines and limits the prerogatives and possible actions that parties have and undertake; respectively. Given the nature of a startup's corporate structure – a high-risk high-return high-growth, and very dependent on consistent cash injection and control distribution – private ordering through shareholder's agreements seems to be more valuable than a restrictive legal framework, whereby parties establish the necessary conditions they deem valuable to creating trust between the various constituents in the company.

parties, whereas the shareholders agreements are only enforceable among their parties and not against anybody else.

A shareholders agreement might come a bit later than sooner, i.e., with a big round of fundraising rather than with seeding, which is increasingly being undertaken through lighter instruments. (More on both shareholders and associated bundle agreements at a later section.) The caveat here is that the law and the templates should not be overly restrictive as would invalidate the independent arrangements reached. This feeds back into the loop of mandatory and supplementary rules, what might be contracted around and what might represent public order. Where a jurisdiction provides neither of the foregoing or puts major limitations on either, investors and startups pursue other jurisdictions, motivated by confidence in such investment regimes accommodation of their structuring concerns.

The specifics of availability of a proper company form – holding or operating - serving the needs of investors and investees are unfortunately neither obvious nor straightforward. Many countries boasting promising startups in need of funding consider that their laws are already sufficient to support startup investing and believe that investors should support the country in its development and trust its laws. Other jurisdictions think that while reforming their laws to respond to the needs of investors, investors should appreciate the efforts expended and not ask local startups to incorporate a holding company elsewhere as a prerequisite to supplying them with funding. Neither of these groups are willing to acknowledge that they should bring their corporate and contract laws into line with those in more startup-friendly jurisdictions. Further, they do not recognize that international investors will not consider investing until that has been achieved. Countries in denial about their laws are not robust enough to lure startup investments for growth. The same goes for countries reforming their laws piecemeal, without grasping the breadth of investor-investee startup structuring needs. The ultimate effect of this lacking approach is to cast doubt upon whether the jurisdiction is indeed startup-friendly.

3.3 Tensions Inherent in the Startup Investment Model

The startup-founder-investor dynamic is multifaceted. Its legality is centered on trust-enhancing agreements,

which for their turn were developed to hedge against tensions inherent in the startup investment model itself, as to be discussed below. On the one hand, founders seek funds, while on the other, investors seek guarantees to their investment. Investors provide the cash for the startup while taking a minority position. The minority position investors find themselves in is the source of most investors worry. Many of the legal issues relating to startup investing revolve around securing protection against founding entrepreneurs' opportunism. As such, compromises need to be made by both parties (with the constant awareness that those compromises will vary as the start-up enters more advanced stages in its life cycle). Deal term negotiations is a main pillar in startup investing[7]. (Agency Costs of Venture Capitalist Control in Startups – Jesse M. Fried and Mira Ganor).

In the earliest stages of a startup, angel investors are already taking a risk, investing when traditional investors would not[8]. (Designing Startup Corporate Law: A Minimum Viable Product – Alvaro Pereira). While venture capitalists invest in still a high-risk asset class, they take lesser risks than business angels. A startup could fail at any stage until it has matured into a solid business or was acquired along the way. Signs along the way to maturity and stability include developing a robust product, putting it to market, earning revenues, hitting breakeven, making profits,

[7] Whether opportunistic behavior is engaged by founders or investors of different classes, the end result remains the same. While founder's opportunistic behavior stems from their insider information, knowledge and know-how of the company's business and activity– among many other things – investors' opportunistic behavior finds its source mainly in the leverage they possess when providing the needed funds that the startup requires. Nonetheless, any opportunism is never good behavior, since the consequences thereof are agency costs that startups cannot afford.

[8] The author argues that the congruence of both corporate law and contract law is necessary for the success of a startup. Corporate law should establish rules, centered on (i) governance and board control; (ii) shares - their allocation and issuance; and (iii) Shareholders' Agreements, and its private ordering. Providing adequate rules centered on these factors is the means to achieving corporate and contract law congruence, as well as startup success. These factors are referred to as Startup Corporate Law (SCL) and through them, startup parties can create mutually beneficial and trust-enhancing provisions that would lead to startup success and growth.

provisioning reserves, and ultimately having cash profits for distribution as dividends.

Three hallmark risks associated with startup investing have been highlighted by Darian Ibrahim, namely: (i) incertitude of business model; (ii) asymmetry of information between founding entrepreneurs and investors; and (iii) agency costs leading to entrepreneur opportunism[9]. (The (Not So) Puzzling Behavior of Angel Investors – Darian Ibrahim).

Many times, business models turn out to be something between success and failure, and the startup may need to pivot more than once. It is at the point where there is a product market fit, typically based on a minimum viable product, that the business model may start delivering success. Ultimate success would depend on many other factors, from proper funding at each growth cycle, to continuous innovation, initiative, and operational excellence. Incertitude of business model is one hallmark risk for startup investors to consider and try to mitigate.

The second type of risk, startup founders and key employees who may have employee stock option plans (ESOPs, more on ESOPSs later), accumulate detailed knowledge about the startup itself as they manage. Such knowledge may place them in an advantageous position vis-a-vis the startup's investor. Consequently, the particular startup context may build and feed a power dynamic among those involved in daily execution and those who are outside, including investors. The entrepreneurs and key employees would have knowledge of the pipeline of the business as well as of those clients and vendors already contracted, actual volume of business attracted and expected to close, receivables and liabilities, etc. Without proper reporting and monitoring, founders and management may present an unrealistic picture of a startup's standing. Among the worse things that could happen by founders and key employees are manipulation of a startup's numbers, or passing of the corporate opportunity to their own persons or other entities they could be involved with, rather than to the startup for which they received investor funds.

Third, entrepreneurs could engage in opportunistic behavior, owing to the fact that they typically own the majority of their startups at inception and during the earlier stages of startup growth. With majority voting as the standard voting formula under corporate law, entrepreneurs would get their way against the will of minority shareholders. The range of opportunistic behavior that may be exhibited by founding entrepreneurs is almost infinite. It is no wonder that much of the investment agreements attempt to forestall entrepreneurial opportunism of all kinds.

Troubling examples of entrepreneurial opportunism include deciding to change the purpose and activities of the startup, leaving the investors essentially invested in a business they did not sign up for. Threatening to leave startup management may reveal an opportunistic behavior as well, as investors will be left without the team they had bet on while investing. Such a threat is ever present from inception until maturity. At the later stages of a startup's growth, however, threatening to leave management might not matter as much, as the startup and its investors could hire a team of professional managers to fill in. In other words, the

9 For further clarifications and deeper insights on investor and founder opportunism.

need for the founders' vision, critically necessary at the earliest stages of a startup, would by now have dwindled. A more extreme example of entrepreneurial opportunism is voting to sell the company, in a deal that may be lucrative to the founding entrepreneurs and a net loss to the investors. Such a situation may obtain if the founding entrepreneurs decide to exit the company at a price less than the valuation at which the investors had joined. Entrepreneurs provide limited or no cash into the startup and invariably seek investors' funds to infuse into startup capital and operations; thus, less than fair value cash received through the opportunistic behavior of some entrepreneurs would be welcome to them even if it causes losses to investors. The phenomenon is referred to as "beach money exits".[10] (Beach Money Exits – Mathew Wansley).

3.4 Entrepreneur Opportunism Risks

3.4.1 Commitment to the Business

The initial excitement investors may feel is based on their interest in the aggregate perceived value of the entire team, their idea, the space in which the startup operates, and the markets it promises to serve. But time and again, investors affirm that they bet on the team, especially in the early stages of the startup. The right founding team could pivot and re-pivot, as needed, to deliver a startup from failure to success. Scaling the startup might draw upon the same skillset of the founding team or may need higher order skills, probably in organization and management. All along, the commitment of the entrepreneurs is perceived by investors as an essential ingredient in the recipe for startup success.

Entrepreneurs' commitment to managing the startup reassures investors about the prospects for the startup. The entailed expectations based on this commitment are manifold. Entrepreneurs' expectations for the company and the company's expectations of the entrepreneurs as managers need to be detailed for the benefit of both, and the legal and policy framework in the jurisdiction should be able to solidify these expectations links.

3.4.2 Diminution of Investors Shareholding Value

Startup investors make investments to realize profits. Most investors aim for maximum profits unless there is additional motivation or consideration for the investment, as in the case of impact investing, such as social or environmental. The reported average success rate in startup investing is 20% globally. This statistical reality is a fact of the market that all angel investors accept. To mitigate against failure and to increase their chances of success, startup investors each build a portfolio of investee companies. What investors are not willing to accept, however, is having a startup fail because of actions of the entrepreneurs. Startup investors would not accept entrepreneurs diminishing the value of the startup through compromising or circumventing its gains, realized or prospective.
Examples of actions detrimental to investor interests, where entrepreneurs maintain a majority of the startup's shares, include selling the company short, as in the situations referred to as beach money exits. This term typically refers to founding entrepreneurs seeking to exit at a valuation less than the valuation at which current or previous investors joined. Such a sale might be coupled with a declaration by the entrepreneurs of a wish to depart altogether from the startup or, alternatively, to continue to manage with no aligned interests with the startup since they are no longer shareholders. Another such action would be selling the company, in whole or in part, prematurely, when its value was still building. Finally, the entrepreneurs might sell the company at less than a fair market value.

Similarly, a dilution of current investors' shareholding might result when entrepreneurs cause the startup to raise funds at valuations less than previous rounds. Such fundraising may also bring unwanted investors into the startup (e.g., if some of them have invested in competition). Overall, investors would fear situations such as mergers, acquisitions, consolidations, sales or dissolution that would leave the entrepreneurs unjustly enriched at the expense of the investors, and the investors' shareholding value correspondingly diminished.

3.4.3 Domination of Corporate Governance

Corporate governance is a cornerstone of corporate life. Corporate governance regulates and determines company decisions, periodic as well as episodic. It flows from corporate law and the constitutional company documents including contracts, statutes and bylaws, and any supplementary documents relevant to the structure of the business. Corporate governance is exercised predominantly through (i) the constitutional assembly of the company, in the form of general assembly meetings, and (ii) the board meetings. Executive management takes its mandate indirectly from the constitutional assembly and directly

[10] Adding more context to the Beach Money Exits; Founders and Investors typically have varying, and most likely, conflicting interests. While the former can be shortsighted, the latter is very patient. As such while investors are more inclined to keeping the company growing until an eventual IPO, founders might lean more to a quick exit, if the event presents itself. Provided that company control is usually within founders' grasp at the earlier stages of the startup's lifecycle, if founders show any apparent opportunistic behaviors, avoiding a Beach Money Exit would prove difficult for investors, whom lack any considerable company control.

from the board, but that is a sub-topic of broader corporate governance not under discussion for the purposes of this report.

Based on corporate law and the default rules contained therein and expressed in the various constitutional company documents, the majority shareholders would dominate corporate governance in a democratic vote. This is not in the interest of minority shareholders, who invariably include the investors in startup companies. Investors and their lawyers are always concerned with avoiding such dominance. There are as many solutions to such concerns as there are investors and lawyers entertaining them.

Three core matters relating to corporate governance in startups are (i) the voting weights of the different classes of shares issued to investors (assuming it is possible to issue different classes of shares); (ii) mechanisms to balance the rights of investors and entrepreneurs other than voting, where voting is not the appropriate option; and (iii) board seats. Investors expect the legal and policy framework of the competing jurisdiction to adequately address the voting issue and related core matters.

3.4.4 Misappropriation of Company Assets

Misappropriation of company assets by entrepreneurs or employees would diminish the value of the company to the extent it occurred. Corporate law and constitutional company documents, such as contracts, statutes, bylaws and circulars, hedge against such opportunistic behavior. Misappropriation usually relates to physical (tangible) assets or intellectual (intangible) assets. A mix of both physical and intellectual property assets are the norm in all companies, including startups. In comparison, however, startups assets are primarily intellectual and intangible, owing to their increasing dependence on technology. The following discussion will elaborate on intellectual property rights and the concerns that investors will have in that regard.

Most high growth startups are technology driven, and intellectual property is the main asset category upon which such startups build their value. Intellectual property spans patents, copyrights, trademarks, trade-secrets, and numerous variants of them. As intangible assets, intellectual property requires protections different from those of physical assets. Legal protection of intellectual property rights is obtained through registration with relevant authorities in the countries where protection is sought, or through a web of contracts preserving know-how internally within the startup and requiring confidentiality and sharing of information on a need-to-know basis. Protection of intellectual property rights is not a one-time effort by the startup; it needs to be sustained through a startup's life, from inception and carrying forward into its later phases. A formidable company would continue to observe protection of its intellectual property. Each type of intellectual property protection has its own intricacies that ought to be separately observed.

3.5 Best Practices

International investors look for the best practices to provide them with familiar investment territory. Professional international - and increasingly

also local - startup investors invest in so many companies as they follow a portfolio approach, and best practices appetize them. Every seasoned investor understands that, in investing, form and substance go hand in hand. The below best practices have evolved to fill the gap.

3.5.1 Milestone Disbursements, Vesting, and Lock-ups

To align startup-founder-investor interests, best practices have evolved to persuade the entrepreneur to remain observant of the best interests of the startup, and indirectly of investor interests. Investors could negotiate benefits more aligned to their interests, as alluded to above. This dynamic is composed of various legal mechanisms that work in tandem to achieve the set goals.

First, investment funding may be disbursed in tranches, with each tranche released upon achieving an agreed-upon milestone. If the entrepreneurs do not deliver the promised results, the investors would not release the next tranche. Ending a startup by not following through with the next tranche might be a severe measure to apply but might be needed as well. This would save the investment in part, as investors would not pour good money after bad.[11] (Reciprocal Fairness, Strategic Behavior and Joint-Venture Survival: A Theory of Venture Capital Financed Firms – Manuel A. Utset).

Second, entrepreneurs' shares in the startup might be vested over an agreed period and possibly upon reaching milestones generally set in a business plan. Founder shares vesting allows them to keep their already vested shares upon departure. As entrepreneurs contribute a combination of idea, vision, and implementation (by way of work and less cash), it is only understandable that earning their shares should be a function of investing their sustained commitment until the startup delivers. The time horizon applied is typically four years, with shares vesting initially at the end of the first year - (the one year cliff), and monthly thereafter.

Vesting has become a defining component of the startup genome, as it aligns the interests of the entrepreneurs with the startup and the projections they agreed to in the business plan. If an entrepreneur leaves the startup prematurely, s/he would most likely be substituted unless the startup is liquidated, and the substitute would require a set of incentives similar to those of the departing entrepreneur. Unvested shares could in this event go to the substitute, or alternatively be reacquired by the startup or redistributed to other shareholders, including co-founders or key employees. Key employees are usually compensated with option pools, which similarly vest as with founding entrepreneurs.

Third, entrepreneurs' management is required in the startup and therefore a management commitment is extracted from the entrepreneur for a number of years considered sufficient to establish the startup's business and hopefully to scale it too. The typical number of years for management commitment is four years, as with vesting. The management commitment is assured by a strong employee agreement protecting the startup from management opportunism. The

[11] Since startup founders usually have the upper hand in the earlier stages of the startup life-cycle, through their majority ownership percentage in the company, and their extensive informational rights and access in company, whom surpass, in comparison, any leverages acquired by early stage investors; among others. Investors tend to use various incentives and mechanics in order to align their interests with those of the founders, and balance out those early stage discrepancies present between them and the founders. Stage financing is one of those mechanics, and is often coupled with other mechanics, that together, mitigate any prospects of founder opportunistic behavior.

employment agreement would guarantee that (i) the efforts of the entrepreneur are solely expended within the startup; (ii) confidential information within the knowledge of the entrepreneur is not divulged to the detriment of the startup; (iii) any and all IPR produced by the entrepreneur in the science and business areas of the startup is assigned to the startup; and (iv) corporate opportunity remains for the sole use of the startup. Additionally, the entrepreneur shall not compete with the startup's business during his tenure or after, nor solicit any of the startup's employees or clients, including for a period after his/her departure from the startup.

Finally, the limitations on the entrepreneur's share sale in startup investment contracts reinforces an alignment of the startup, entrepreneur, and investor interests. The assumption is that the more commitment the entrepreneur retains through a lock-up mechanism of his/her vested equity, the more s/he would give priority to the startup's affairs. Lock-up periods may vary, but usually apply through the vesting period and for one year thereafter. They may also apply for one year from leaving the startup in the case of a good leaver. Bad leavers forfeit their unvested shares. In most cases, the entrepreneur is obliged to offer her/his shares for sale to the startup first.

3.5.2 Board Composition and Reserved Matters

If the Startup is a joint stock company (JSC), it is typically managed by a board of directors. The board of directors may delegate its functions to an executive management team from the board or one hired for that specific purpose or a mix of both. Board members are typically elected through the shareholders base of the company, although for better governance, independent board members are increasingly appointed to diversify and enrich board composition.[12] (Foundations of Corporate Law – John Armour). Corporate law as standard assigns a vote for every share, or more in the case of holding preference shares, as will be discussed in the next section. Such are the default positions in the company constitutional documents – the certificate of incorporation and the bylaws of a company. Even with preference shares, investors with minority shareholdings might not be satisfied to count on representation that would give them less influence in the startup's life cycle until later, when one or more investors will have accumulated enough shareholding to have meaningful say in company governance through their preference shares. As the board is very important for startup investors' control prerogatives, most investors prefer to contract their board representation rather than go with statutory (voting) norms.

Contracting board representation has the objective of reassuring startup investors that the management would not overlook investors' negotiated rights and expectations nor act opportunistically in relation thereto. A major investor could contract such rights individually, so long as its investment meets a certain threshold and stays above that threshold to continue to enjoy those rights. Alternatively, investors of the same shareholding class may collectively negotiate their class rights. Voting rights may be negotiated as well, frequently requiring the company to cooperate in voting the major investors' nominees to the board, and for major shareholders to vote for each other's designees to the board.

Board composition and investor-negotiated board rights are delicate matters, as each and all board members should act in the best interests of the company. Where board members represent a specific investor or groups of investors, conflict of interest as well as the board members' fiduciary obligations become an issue due to the varied constituencies present in the company - entrepreneurs, investors, and others. Fiduciary obligations encompass various duties of the board members or the controlling shareholders towards the company and the wider shareholders base. Basic among these are the duties of loyalty and care. Originally, fiduciary obligations are statutory norms, and many jurisdictions disallow their waivers by way of contracting. Practically, startup investors need to contract around them to secure control guarantees, even where they hold minority stakes in a startup. Cumulative voting rights is another way of securing investors' board influence, but are not deemed sufficient nor as effective as contractually negotiated rights.

Another frequently used mechanism to avoid opportunistic management behavior against the interests of investors is to include a list of reserved matters and requiring the affirmative vote of the director representing the major investor or a specific class of investors. These reserved matters are of consequential effect on the startup, and not exercised

[11] The author explains that a healthy functioning corporate form needs to account for five hallmark features: (i) Legal personality; (ii) Limited liability; (iii) Transferable shares; (iv) Delegated management; and (v) Investor ownership. While all hallmarks are important – as discussed in this report – the fourth hallmark warrants more attention. The functioning of a company's board is quintessential to the growth of the company. When it comes to startups – a multi-faceted entity, with multiple constituents each with their own interests in mind – its board needs to be finely tuned, in order to provide protection and comfort to the company's constituents as well as make the best decision for company growth.

[13] The act of removing the entrepreneur-founder from any managerial position is commonly referred to as "Founder's Disease". Investors routinely assume that entrepreneurs, while highly capable of creating a product/service, are incapable of transitioning from an innovator to a successful manager, which leads to their removal and outright firing from the company from their managerial position to be then replaced by a capable and professional manager. While this removal is detrimental to founders, such negative consequences can be viewed nonetheless as a positive sign of founder's success in growing a flourishing company. Since the mere prospect of removing the founder – the brains behind the company and its product/service – means that the company has entered a stage of success that most companies would dream to achieve.

in the normal course of business. They include, among others, a change of control, taking loans outside the ordinary course of business, and hiring or firing of the CEO or the CFO[13] (Startup Governance – Elisabeth Pollman; and Reciprocal Fairness, Strategic Behavior and Joint-Venture Survival: A Theory of Venture capital Financed Firms – Manual A. Utset), and certain types or thresholds of expenditures.

The point to stress here is that negotiation of board rights and reserved matters are contextual and consider the power positions playing out at the time of negotiation, most likely at the time of a new investment round. The contractual context of these negotiated agreements is the shareholders agreement, complimenting the constitutional company documents, where they may not be flexible enough to accommodate rights sought and needed by investors.

3.5.3 Preference Shares and Liquidation

Investors seek additional protection in respect of their investment by taking preference shares in the startup, rather than the common shares taken by the entrepreneurs, key employees, and consultants. A preference share may provide preferences related to voting, dividend distribution, and liquidation. Corporate laws do not allow combining voting and liquidation preferences, to avoid voting opportunistically for company liquidation and benefiting from that opportunism. It is to be noted that each preference type provides a different protection to the preferred shareholder. Additionally, different preference classes of shares may exist. In this case, it would reflect the weight of the investor or the round. It would also be possible to mix and match different share classes and various preference types.

Voting Preference

A voting preference allows the holder to have more say in company governance. The preference may stipulate 2 to 1 or more. A different ratio can be agreed between those receiving the preference and the company. In the case of the startup, and as the investors are in a clear minority position at the initial stages of investing, a voting preference is deemed non-meaningful. The investors commitment to the founding entrepreneurs and the startup is still being rolled out from idea to MVP to a workable business model. It is in the interest of all the startup's shareholders to leave the startup and its decision making ultimately in the hands of its founding team to increase a startup's chances of success. Even though investments are much needed for the startup to continue its onward journey, any investment made at the initial stages of the startup's life is modest when compared to later investments. With substantial fundraising in the later stages of a startup's growth, and with investors holding more equity percentages in the startup, it becomes meaningful for investors to negotiate a voting preference. In an interesting reversal, USA founders are permitted to hold super voting shares, possibly reaching a ratio of 10:1.[14] (The Non-Transferability of Super Voting Power: Analyzing the "Conversion Feature" in Dual-Class Technology Firms – Clara Hochleitner). If a startup does extremely well, as with Facebook or Google, and as the founding entrepreneurs' equity percentages are diluted compared to investors, it is the founding entrepreneurs who may insist on holding super voting shares. Otherwise, the entrepreneurs may threaten to leave the company management that they now hold minority equity stakes in. Indeed, voting preferences are contextual, and all participants involved with a startup know their context well and contract around it to optimize or at least balance their say in startup governance.

Dividend Preference

The dividend distribution preference requires the company to make a distribution at a certain percentage annually to the holder of the preference. Naturally, this is not prevalent in the early startup investing stages, as most startups struggle to get to break even in terms of revenues to expenditures, and then to capture more market and expand. At those points, the startup might not be making profits, and therefore has no profits to distribute. On a more positive note, the startup might be making profits, but need to reinvest those profits to finance its growth, and hence would end up without distributable profits. In brief, most startups fundraise most of the time, especially startups aiming to reach blitz scaling. Any attempt at dividend distribution in the interim may be considered unrealistic and can actually hurt the company's prospects to fundraise from future investors. The general expectation of investors to profit from a startup is to realize capital gains appreciation at exit, and much less through periodic dividend distribution. Hence, profits are suppressed for the purposes of dividend distribution. Where a dividend distribution preference is negotiated, it is usually not distributed annually for the reasons just given but may accumulate towards any liquidity event. In this case, the dividend distribution preference holder would receive the agreed dividend percentage on a cumulative basis, before moving at his/her election to enjoy the common share of the startup, having appreciated. Alternatively, a startup turning into a lifestyle business may stop its continued efforts at fundraising; and once it has profits

[14] Super Voting shares are usually very contingent. While they do confer a different ratio than ordinary shares, that are more than 1 to 1, the nature of their issuance is founder-specific – having a personal characteristic attached to it. They are mostly rare to find in the hands of any startup shareholder other than its founders, since they are contingent upon the following: (i) the certificate of incorporation usually structures its viability and limitations; (ii) its viability is its issuance to founder, with purposes of keeping the founder involved in company control even if his ownership is diluted as more actors are introduced in the company; and (iii) its limitation is centered around a conversion feature that dictates the conditions to turning super voting shares to normal voting shares – and since they are founder-specific, the common reason to its downgrade is its transfer from founders to others.

it may at its management's recommendation start to distribute dividends.

Liquidation Preference

The liquidation preference is important to the startup investing process and is the most common preference deployed by investors in the early stages of startup investing. The liquidation preference entitles the investor to receive typically one times the investment the investor invested in the startup. It activates after outside debtors debts have been paid, and before payment of the startup's common equity shareholders debts commences. The liquidation preference puts the investor in a middle position between debtors and common shareholders. A liquidation preference of more than one times the investment made is considered excessive in the initial rounds. Later, the liquidation preference may be one and a half times, two times, or even more. The liquidation preference allows investors to salvage what they could of the investment when the startup is undergoing liquidation.[15] (Liquidation Rights and Incentives Misalignment in Start-up Financing – Michael Klausner).

3.5.4 Pro-rata and Anti-Dilution

As a startup evolves from stage to stage, proving to be a success in the interim, it may continue to seek funding at multiples of the initial valuation to achieve scaling and maturity. The earlier investors already engaged with the startup, especially those who allow for follow-on investing, might worry about seeing their shareholdings too diluted with the larger investment rounds coming in. To maintain their shareholding percentage of the equity of the startups they invested in earlier, and to avoid a prospective dilution, early investors would need to secure their right to reinvest by way of follow-on. Most early investors require pro-rata rights for that purpose. An example of the importance of stipulating a pro-rata in the early investor agreements is the case of a pre-seed fund deploying a 'spray and pray' investment thesis. Funders investing with this strategy would typically be mandated to revisit their investee portfolio startups and follow-on with the more promising ones. If they have not negotiated a pro-rata right to achieve that, they risk missing out when it is time to follow-on. Depending on how their agreement is negotiated and drafted, some early investors might be able to sell their pro-rata rights to subscribe into future rounds to other investors and make money off that.

Anti-dilution is another protection that is highly regarded by investors. It simulates pro-rata in part as it allows early investors to subscribe into future rounds of investment to maintain their shareholding percentage as earlier invested. Anti-dilution exceeds pro-rata, however, as it contains a further important protection to the investor, namely maintaining the valuation of the earlier investment made as a floor for future valuations. Funding rounds at lower valuations than those established for earlier rounds are referred to as down-rounds. For instance, if the earlier investor invests at a valuation of one million dollars, any future valuation for the purposes of receiving further investment into the company has to be higher. If not, the earlier investor would be entitled to receive shares from the company founders to reach a weighted average balance or the full differential between the two valuations. Two anti-dilution protection mechanisms exist, and the choice between them is a function of negotiation between the startup and its investors. Weighted average anti-dilution considers the average between the two valuations and entitles the earlier investor to the balance between what s/he invested in and the weighted average. A full ratchet anti-dilution is a more aggressive mechanism entitling

[15] While there are 3 types of preferred stock issuable to an investor. The most common in the startup ecosystem is the liquidation preference, given the startup's high-risk high-return nature. While no revenues or profits are presumed of a startup in its earlier stage, the anticipated return lies when it comes time to exit through the numerous liquidity event possible – of such exit possibilities is an eventual IPO. However, as more investors enter the fray, more liquidation rights are demanded, and each new demand confers a higher in class liquidation right, which at the eventual sale of the startup, might cause nefarious consequences between founders and different class investors.

[16] Among the many agency problems present in a startup, horizontal agency problems amongst various classes of investors are the most prevalent. While pro-rata protection is to ensure that previous investors ownership stays the same in the next round of investment. Anti-dilution protection is sought after in case of an eventual down-round investment. Both are sought after to reduce any agency costs in the form of a devaluation of investors' shareholding. To put more emphasis on why anti-dilution provisions are negotiated; when a company is presumed to be in a down-round, automatically any shares issued previous to said event would lose value, thus causing the agency costs that investors have to bear, even if they use their anti-dilutive protection. The value lost cannot be gained so easily as people might presume. (A rigorous explanation of why share value cannot be regained is detailed from pages 82 to 90 of the law review article "Venture Capital, Agency Costs, and the False Dichotomy of the Corporation" written by Professor Robert P. Bartlett).

the earlier investor to the full differential between the valuation s/he invested in and the valuation of the down-round investors. Anti-dilution is used in part to mitigate against hyped valuations in the world of startup investing when investors are ready to invest at inexplicable valuations in the spur of the moment. The entrepreneurs promise the skies to investors, and market reality grounds them both later.[16] (Venture Capital, Agency Costs, and the False Dichotomy of the Corporation – Robert P. Bartlett).

3.5.5 Convertible Notes and the 'Quick-Funding' Gap

The startup investing world is based around speed, with blitz growth at the core. Startups need and feel entitled to receive sizable resources, and right away, to focus on growth. A startup not solidifying the markets it intends to occupy believes it could be inviting competition or new challengers to eat away its potential growth share. Traditional corporate financings that go by the book in terms of lengthy due diligence are deemed inexpedient to support startups in immediate need of funding - (the 'quick-funding' gap). In return, investors have a 'fear of missing out'. They could not stand neutral on a fast-moving train and miss out on opportunities.[17] (Valuing Young Startups is Unavoidably Difficult: Using (And Misusing) Deferred-Equity Instruments for Seed Investing – John L. Orcutt).

The advantage of the convertible note to startup investing is that it postpones agreement on valuation till a 'qualified financing round' has been achieved. Convertible notes allow investors to extend by way of lending the needed funds for the startup's quick action, and to retain the right to elect repayment of the money lent at a specified maturity date or to have the convertible note amount converted into shares in the company at that date or at other triggers mutually negotiated and agreed. There are numerous types of convertible notes, but they all satisfy the 'fund now and valuate later' need.

A qualified financing round is a substantial fundraising round in the early growth stages of the startup compared to its earlier rounds. Qualified financing rounds are equity based and thus establish the valuation of the startup to the benefit of the new investors as well as the previous investors who hold convertible notes and are now converting. A qualified financing round usually follows the angel round. Innovative investment instruments have evolved to fill this 'quick-funding' gap in the interim.

In fact, the investing instruments perceived as innovative were a revamp of older instruments mostly, in particular the convertible note and its variants. [18](The Evolution of Entrepreneurial Finance: A New Typology – J. Brad Bernthal). The two main protagonists in the branded convertible notes space that came to dominate are the Y Combinator with its now famous Simple Agreement for Future Equity (SAFE) and the 500 Startups (now renamed as 500 Global) with its Keep It Simple Security (KISS). They each downplay repayment of the convertible note amount, with repayment historically representing the most teeth in a convertible promissory note. They focus rather on conversion events into the startup's equity and related rights, and rights to liquidity proceeds more generally. As repayment of the note amount in the event of a startup's failure becomes somewhat muted, the respective SAFE or KISS brand friendliness to entrepreneurs becomes more pronounced, hoping to entice entrepreneurs in the Valley and internationally to use them as a first choice for onboarding early-stage investors.

Nevertheless, simplifications and clarifications have been features of all revamped note versions to bring them into line with the nature of startup investing. As most or all of the convertible note amounts extended are spent by the startup within the anticipated time window, irrespective of the startup's success or failure, repayment of the convertible note amount would be impracticable. With that in mind, and with an eye on assuring a sense of security to startups with higher chances at success or failure, different institutional investors have led their own independent efforts to produce note versions comforting to startups. Part of the motivation here is that many times the founding entrepreneurs of a failing startup may decide individually

[17] "There is no getting around it: valuing young startups is unavoidably difficult. Unicorns and other high-flying startups get the press, but every startup must first launch and grow. […] Most young startups need outside capital to get through their early stages (commonly referred to as "seed investing or "seed financing") but finding willing investors can be challenging" As the author states, valuating startups is a difficult task, since they are unlike already successful and mature corporations, that have a methodic and systematic measuring tool to their value and potential for growth. Making the act of investing at earlier stages, and until the startup can be measured like any mature company, a gamble for the willing investors. As a consequence, innovative measures are created and put in place as a response to such difficulty. This innovative measure revolves around the notion of deferred-equity contracts (such as SAFE, KISS, and more generally Convertible notes) as a replacement to traditional investment contracts. The main gain to such contracts is the fact that investors can invest in the company and acquire their shares at a later time in reliance to its future valuation in the next round of investment – commonly referred to as a "qualified financing round". The shares they acquire are not valued based on the round they invest in, but rather based on (i) a future round of investment; (ii) with an explicit valuation of the company upon such round of investment; and (iii) having an explicit price per share accounted for; all the above being contractual conditions, written and consensual, that upon realization make the innovative contract effective; "With deferred-equity instruments, investors still purchase a percentage of the company. However, the percentage amount is not determined until a later date, typically when a future stock offering occurs. Pricing is thus deferred to the subsequent offering".

[18] The author expands further on the notion of innovative agreements, by listing various traditional and innovative investment instruments, with some focusing on debt (such as Revenue Based Financing and Demand Dividend), some focusing on equity (such as convertible preferred equity and Light Preferred Equity) , some a mix of debt and equity – which are usually the deferred-equity type of investment instruments – (such as Convertible Debt and its other various variants), and finally some that go beyond the norm of debt and/or equity investment instruments (such as the Prepayment method of investing).

or together to initiate a new startup capitalizing on the lessons learned, and the investor may wish to join their next venture to benefit from the experience they gained earlier at investors' expense. It is believed that failing entrepreneurs have better chances at success in their next startup.

The initial success of SAFE and KISS investment models and their terms has led to their globalization. They have both undergone various iterations to reach their current status. Also, both have developed versions suiting other jurisdictions, depending on the incorporation preferences of the startup's founders and their investors. Other institutional efforts at establishing branded convertible notes are numerous but are meeting less luck at internationalization. Tech Stars and SOCV are two examples of the ones trying, amongst many others.

Revenue Based Finance (RBF) is another financial mechanism bridging the startup 'quick-funding' gap. Like a convertible note, RBF does not need to establish a valuation for the startup, and many times utilizes an abridged process of due diligence. But unlike a convertible note, RBF's main emphasis is on whether a startup is able to repay an agreed percentage of its topline revenues to the investors, starting a few months from the initial investment. Repayment is set for an agreed number of months or years, as commensurate with the financing extended and the line of business the startup is engaged in. The payment period is usually monthly, while settlement may be quarterly or twice annually. This makes RBF inadvisable for startups without revenues. RBF investors share some risk with the startup by shouldering the volatility of the repayment as payment installments vary based on actual revenues for the payment period. As startup investors measure their returns in terms of multiples, RBF needs to be structured as an investment agreement sharing in revenue, rather than as a loan agreement to be paid based on time only, which may cause RBF to clash with usury laws, where applicable.[19] (The Evolution of Entrepreneurial Finance: A New Typology – J. Brad Bernthal).

From the above, it is evident that innovative financial instruments help in bridging the 'quick-funding' gap that most startups suffer from. The convertible note and RBF are two such instruments. Each had a history different from its current adaptation to startup funding needs: the convertible note was based on the promissory note, having repayment with interest or not at its core; RBF catered to the unpredictable returns associated with farming seasonality, hence its link to a percentage of revenues.

These two particular innovative financial instruments each relax the cap table of a startup (i) until conversion takes place with a qualified financing round in the case of a convertible note, or (ii) indefinitely, as in the case of a convertible note early liquidity event materializing, or (iii) RBF, sitting investors altogether out of the cap table of the startup.

3.5.6 Employee Incentives: Employee Stock Options and Phantom Shares

A startup's success depends initially on its founding team and the first employees who, all together, share the same vision and provide the energy to implement it. Potential investors should insist that such a "dream team" be complete from the beginning or as soon as possible.

To recruit and retain and align the interests of key employees, a startup has different options. If the startup is well funded, it could pay market rates for its key employees' services. If the startup is underfunded initially, which is usually the case, it may look for other ways to recruit and retain key employees. A best practice of creating an option pool from the startup's equity has evolved to meet these needs. The option pool comes from founders' shares. Such shares are invariably common shares, non-voting, and are acquired through a vesting mechanism.[20] (Startup Governance – Elisabeth Pollman). The option shares are always non-voting to avoid intervention with management or a liquidity event (especially exit, and associated holdout scenarios) through a share vote. Option shares may be allocated, additionally, towards consultants or board members. The rationale behind the option pool shares is (i) to incentivize key employees; (ii) to align their interest with the startup's growth prospects; and (iii) sometimes decrease salary expenditures without compromising talent, as cash and liquidity are scarce for a startup.

Option pools involve the creation of (i) the option pool plan, which sets the parameters of the options to be periodically or episodically granted to beneficiaries of the plan, with or without achievable milestones; and (ii) the option grant agreement, with exercise notice as an attachment. It is to be noted that share option pools maintain an institutional attribute, insofar as they become tied to formal company structures

[19] For more insight on the mechanics and advantages of the Revenue Based Financing investment instrument, J. Brad Bernthal's "The Evolution of Entrepreneurial Finance: A New Typology" is recommended.

[20] Such Employee Stock-Based Compensation are means to (i) motivate employees to be more efficient and effective in their work, with a promise of eventual ownership, that after a vesting period, would serve as cash bonus once they are sold back to the company; (ii) keep key employees from wanting to leave the company, and keep their valuable skills inside the company; and (iii) incentivize various types of investors to invest in the company; since a stock option plan reserved for the team is what investors would like to see in a high-risk high-return type of corporation because their whole gamble relies on the team to perform and contribute effectively and efficiently to bolster startup worth and growth.

and procedures. Thus, option pools relate to the corporate law of the jurisdiction where the company is incorporated. This is unlike other options targeted at incentivizing talent, which remain contractual, although the latter may place heavy demands on startup liquidity at settlement. Examples of the latter category include phantom shares and share appreciation rights which are mostly settled in cash.

Finally, the sale of shares acquired through ESOPs are typically required to be offered first to the startup, second to startup shareholders, and third to outsiders.

3.5.7 Restrictions on Transfer

Startups typically take many years to build value, and all along tend to raise investments. Investors like to invest in primary shares (purchased directly from the startup), and much less if at all in secondary shares (purchased from earlier investors or other shareholders). Hence, the startup participants may find themselves entangled in a process of restrictions on the transfer of shares. The rationale is to avoid opportunism from any shareholder constituency. Share transfer restrictions are therefore a common practice in startups. The best-known restrictions on share transfer include:

a) The right of first refusal, available by statute or agreement affording, but not obligating, the company or fellow shareholders or a group thereof, to buy transfer shares on the same terms and conditions offered by the prospective third-party buyer. The rationale for this is giving priority to the company first, and to fellow investors second, to avoid introducing unknown or unwelcome buyers into company stock, or to satisfy their appetite to purchase more company stock where a fellow shareholder is selling.

   The application of the right of first refusal includes the transferring shareholder serving notifications to the company and fellow shareholders within specific time frames of the details of the offer received. It also includes the decision by the company or the fellow shareholders of their intent to exercise their right of first refusal, etc. Where the company decides to buy the transfer shares, it may decide to buy them all or share the remainder above its need with others. Where, however, other investors decide to exercise their right of first refusal, they would do so pro rata to their current shares. If some of the shareholders exercising their right of first refusal wish to buy less than their pro rata shares, the remaining shareholders would still buy pro rata and any remainder would be picked up by the last interested shareholder(s).

b) The right of first offer is a right available to a shareholder wishing to transfer all or part of his/her shares in the company to offer said shares to the company first and fellow shareholders second, before s/he would solicit offers from outside prospective third-party buyers. The company first, and the shareholders second, may decide to take up the transfer shares, as in the case with the right of first refusal above. If, however, neither the company nor the shareholders exercise their right of priority in purchasing the shares, the shareholder wishing to sell is free to solicit buyers from outside the company and its shareholders.

   The mechanics of notification of the right of first offer, and the decision of the company or the shareholders to respond affirmatively or pass on the offer, are similar to those of the right of first refusal above.

c) Tag-along bestows on its beneficiary the right to demand not to be left behind in a sale transaction coming to one or more other shareholders in the company, usually where the sale involves a certain threshold percentage. As most startups are illiquid, and investors and shareholders more generally are anxious to realize gains from their investments, they each keep their eyes on exit opportunities. The tag-along right, if applicable, requires a selling shareholder to sell his shares as well as ratably the shares of other shareholder beneficiaries of the tag along right, if they decide to exercise their tag-along right and join the sale opportunity.

   This provision affords a minority party in the business the opportunity to join a liquidity event, usually a partial exit. In addition to receiving liquidity, exercise of a tag along right limits the eventuality of a premature exit by the majority shareholders, conferring a possibly unwelcome change of control in the company.

d) Drag-along is a right granting a benefit resembling that obtained through tag-along rights. The function and mechanics of a drag-along are, however, different. A drag along bestows on majority shareholders of a qualified threshold the right to force a minority to participate in an

[21] A deeper understanding of these share sale protections can be found in the sample documents provided by the coalition of attorneys whom specialize in venture capital funding working under the auspices of the NVCA. A relevant sample document is the Right of First Refusal and Co-sale Agreement, which is a template model legal document for best practice share sale protection provisions. Our explanation herein is a quick explanation of their workings, and an analysis to why they are needed. However, the share sale protection provision provided to the investors, are necessary tools to limit entrepreneur, founders, and investors (collectively referred to as shareholder) the freedom of equity sale, since (i) the introduction of new parties to the corporation would prove unwise due to the fragile nature of the startup; one wrong introduction might lead to the demise of the corporation; (ii) such means are to limit parties from freely exiting the company without prior notice to their partners in the venture; and (iii) current parties might want to increase their ownership over the inclusion of new partners in the fray. For further explanation, an in-depth examination of the NVCA's model documents would be required, which surpasses the scope of this report.

eventual sale. A drag-along ensures that 100% of the company is sold, when a prospective buyer requires it to consummate the acquisition transaction. The provision limits a potential holdout by one or more shareholders who may stall the sale transaction unless and until they extract terms to their personal benefit. A holdout risks the welfare of most selling shareholders to benefit a few.[21] (NVCA's Model Legal Documents "Right of First Refusal and Co-Sale Agreement", 2020. (Among many others created by the coalition of attorneys who specialize in venture capital financing).

3.6 Adoption of Best Practices

International investors look for the best practices discussed above to provide them with familiar investment territory. Professional international - and increasingly local - startup investors invest in so many companies as they follow a portfolio approach, and best practices appetize them. Every seasoned investor understands that in investing, form and substance go hand in hand. When investors undertake investments in a fledgling startup ecosystem, they expect the country to have smoothed and clarified its respective laws and regulations to make the decision to invest there a preferred choice, or at least competitive with choices offered in other jurisdictions. If an ecosystem is still evolving, international investors may invest in very lucrative opportunities only; and when they do, they would invariably request the startup to incorporate a holding tier in a jurisdiction they are familiar with. They would also probably co-invest with locals and would rarely invest alone. In all events, an investor would hire professional legal and tax advisors to gain transactional insight, comfort, and support, as needed.

Adoption of the best practices as discussed in this chapter is the only guarantee that a particular jurisdiction can consistently attract international investors, particularly for the larger growth-stage investments. The next chapter will identify the size of the gap between the presented best practices and the realities on the ground in Egypt's legal and policy framework. Accurate identification of the components of such gap and the underlying details associated with it is a prerequisite to any serious effort to make Egypt a competitive jurisdiction for startup investors. It is also crucial for any serious effort aimed at reversing the trend of startups originating in Egypt yet seeking to establish an offshore holding company in other jurisdictions.

CHAPTER 4
THE EGYPT CASE

4.1 Introduction

For the last few years, legal issues around investing in startups in Egypt have become a day-to-day topic of many ecosystem players. These legal issues matter more in the advanced stages of a startup. So as long as investments were small in earlier stages of startups, they were affordable to the local incubators, accelerators, and angels. Investments in this case can be made regardless of the robustness of the investment structure. International investors beg to differ as such robustness matters most to them. For them, the startup needs to be investment ready, and investment readiness means the company is structured to attract investments in its various stages of growth. As Egyptian angels become savvier and more professional, they share the same sentiments of their international counterparts. No angel would wish to invest in a startup to realize later that its structure would not attract future investments or would make them more difficult to secure. The need for legal adequacy, consistency, and enforceability is more pronounced at the level of venture funding, since it involves considerably larger investments.

To this day, Egypt's legal framework has not provided clear and convincing guidance on how it aligns with international best practices. This has been the case for years; little progress has been made to avail the legal institutions and instruments that have become commonplace globally. Paradoxically, startups were initially perceived by the Egyptian government to belong to the small and medium sized enterprises (SME) class. It took some time to appreciate startups as a distinct category. Moreover, most of the concern of consecutive Egyptian governments catered to investments of established magnitude. Authorities seemed to be convinced that Egyptian startups should be capable of attracting investors without a major overhaul of the policy, regulations and laws governing the field. But when Egyptian startups needing funds to scale-up reached out to international investors, they hit the necessity of having a holding tier incorporated in another jurisdiction.

This chapter describes the situation on the ground to help the reader appreciate the gap between these realities and best practices found in investment-friendly jurisdictions. This gap is described in terms of a set of issues that can be mapped to the best practices discussed in the previous chapter

4.2 Issues Relating to Company Constitution

4.2.1 Preference Shares (JSC only)

The Egyptian corporate law allows for voting, dividend distribution, and liquidation share preferences.

GAFI has issued Decree no. 488 of the Year 2019, titled 'the Guidelines Regulating Issuance of Preference Shares at Incorporation or at Joint Stock Companies and Companies Limited by Shares Capital Increase'. The contribution of the guidelines is that it enumerated the various entitlements afforded to preference shareholders. Still, the guidelines came scanty, and the extent of their implementation and the deference they afford to company, shareholders, and new shareholder investors of the various rounds to conclude their own arrangements are not clear. Since share classes are not permitted by Egyptian law, no classes of share preferences are allowed, only share preference types. There are three preference types under Egyptian law:

- Voting: the regulations in Egypt only allow for a ratio of 2:1. For an increased ratio, 75% of the entire constitutional assembly of issued shares must be procured through an extraordinary general assembly meeting.

- Liquidation: the regulations allow all holders of liquidation rights to receive the same liquidation multiple. Later investors would find this stipulation inconvenient, as they are used to negotiating their own round multiples.

Dividends: regulatory practice in Egypt only allow for a ratio of 2:1, although the letter of law is silent on the topic. Investors do not typically require a dividends preference in the initial investment stages, as they expect to profit from capital gains appreciation at exit. Still, VC funds particularly would insist on negotiation inter partes to decide on the multiples of a dividends preference.

4.2.2 No Vesting of Shares (neither LLC nor JSC)

Vesting of shares is not allowed in either company statutes or bylaws, neither originally nor by way of amendment. All shares and stocks need to be issued, allocated, and registered to identifiable shareholders at the time of company formation. The same applies to share issuance at any capital increase. Once the shares and stocks are issued, allocated, and registered in a founder's name, they enjoy rights that are difficult, if at all possible, to strip away or have forfeited. The shareholding status of the founder is thus decoupled from her/his obligations to serve the company.

Vesting issues extend beyond founders' management commitment and achievement of business plan KPIs, as they typically apply also to beneficiaries of employee share options plans (ESOP). ESOPs are allowed by joint stock companies only, and their use is unpopular for perceived difficulty of process, which assume a

mature company size. In addition, most startups in Egypt are formed as LLCs[22]. Vesting also applies to consultants or board members if the startup will not pay cash for their services.

If vesting aligns the incentives of the human capital required to make a startup succeed, the unavailability of vesting drives them apart.[23] (Designing Startup Corporate Law: A Minimum Viable Product – Alvaro Pereira). To remedy the situation by contracting to force a future sale of founder's equity is at best untested by courts in Egypt, and most legal practitioners would find it difficult to believe it could happen smoothly.

4.2.3 Non-voting Shares (neither LLC nor JSC)

Non-voting shares are not allowed into company statutes and bylaws, neither originally nor by way of amendment. The Egyptian corporate law requires that each company share to have a voting right. This runs against the logic of ESOPs, which aims to separate the economic rights of a share from voting and governance rights.

ESOPs aim to incentivize and align ESOP beneficiaries economically only. Giving ESOP beneficiaries voting powers may cause some troubles to the startup in its day-to-day decision making. It may also position certain employees against management and investors, interfering with the original intent of interest alignment.

The more problematic side of giving voting shares to ESOP beneficiaries may appear at the exit, where a vote to sell 100% of the company is typically required by an acquirer for a trade sale to go through. Disgruntled, begrudged, or merely opportunistic ESOP beneficiaries may hold out and stall a sale or impede it. It is to be remembered that ESOP beneficiaries are not part of a shareholders' agreement, which typically treats a position of minority through forcing a drag.

4.2.4 Lock-up (neither LLC nor JSC)

Lock-ups are not allowed into company statutes and bylaws, neither originally nor by way of amendment, although they are critical to keeping founders with a skin in the game and aligned towards the success of the startup. As explained in Chapter 2, a founder able to sell his shares at any given moment in a startup's life might not be incentivized to make it succeed.

4.2.5 Drags and Tags (neither LLC nor JSC)

Drag-along and Tag-along are not included into company statutes and bylaws originally or by way of amendment, although they are important to all shareholders of the company.

4.2.6 Reserved Matters (neither LLC nor JSC)

Reserved matters are matters usually agreed to between entrepreneur-founders and investors to put limitations on company governance and board actions. They are not allowed in the company statues and bylaws, neither originally nor by way of amendment.

4.2.7 Minority Rights (both LLC and JSC)

The Egyptian corporate law provides minority shareholders (investors or not) with few rights, but many of them are inconsequential to majority dominance. Those minority rights relate to challenging certain general assembly meetings – ordinary or extraordinary, and requesting their suspension if the shareholder holds 5% or more of company shares. Where the shareholder holds more than 10% of company shares, s/he has the right to request oversight of company by GAFI, in addition to inspecting company's commutative contracts or any deals entered into with related parties.

A minority holding more than 5% of company shareholding may call, by special process, the holding of an ordinary general assembly meeting, or enlist discussion items to one already called; and a minority holding more than 10% of a company's shareholding may request the holding of an extra-ordinary general assembly meeting, or enlist discussion items to one already called.

More generally, any shareholder (regardless of his shareholding percentage) could request information about and inspection of company records, and take copies thereof, except for the board of directors and the accounting ledgers of the company. The company may however restrict access if it believes sharing the information requested could harm company interests.

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[22] LLCs are easier to form and carry less burdens of governance in comparison to JSCs. LLCs are frequently the advice of lawyers to entrepreneurs as startup chances of success remain law. Once a startup succeeds, it may convert, although conversion is tedious, in particular in respect of tax treatment. At any rate, when the startup prospects for success had been proven, the LLC startup could shoulder the associated costs of conversion into a JSC.

[23] Vesting and Employee Stock Option Plan are both very important to the startup ecosystem, as they incentivize investor to invest in the relevant startup. The lack of such provisions often leads to frustration in financial arrangements, and even if the financial deal is undertaken, the likelihood of governance frustration would occur. Vesting and ESOP work as tools to align founders' – and their key employees' – interests with those of the investors – current and future. Nonetheless, there is no clear evidence that all jurisdictions have such provisions, but there is clear evidence that those that do have Vesting and ESOP provisions are more likely to attract investors than those without.

These minority rights are generally considered to be the core safeguards allowed by Egyptian Law for minority shareholders providing them with enhanced visibility on corporate actions and matters, although their practical effect remain of limited impact. Minority shareholders demand additional guarantees by way of private ordering (predominantly the shareholders agreement) to ensure more powerful and impactful provisions are at their disposal.

4.2.8 Ratchet (neither LLC nor JSC)

The ratchet mechanism is not included in company statutes and bylaws, originally or by way of amendment.

4.3 Issues Relating to Valuation

Startups depend heavily on intangible assets, or pure market growth prospects, and such intangible assets are not adequately taken into account in Egyptian accounting and auditing standards. This repeatedly delivers substantially smaller valuations than investors and startups are willing to agree to. Fair market valuations of startups and scale-ups have therefore proved problematic in the Egyptian startup experience.

The basic premise is that valuations need the approval of the economic performance committee at GAFI (EPC – GAFI). The law requires the company manager or chairman to prepare the valuation study, and to have an auditor certify its content in the cases of LLC and a non-listed JSC. In both cases, the company may use an in-house auditor. For listed companies, there is a requirement of certification by an independent financial advisor (IFA). The EPC-GAFI has over the years relaxed its scrutiny of LLC valuations, whose shareholders by law may not exceed 50; but not of JSC companies with a wider stockholder base. Another aspect of the same problem arises with the injection of funds into a capital increase process, as investors require their investment amounts to be properly accounted for.

In response to EPC-GAFI's requirements of valuation, market practices have aimed at avoiding EPC-GAFI involvement altogether, if possible. The process may be as follows: First, investors would inject the funds into an offshore holding that accommodates startup valuation methods. Second, if the company were very young and the round of investment small, investors may inject funds at the nominal value per share into the Egyptian company, to acquire the equity percentage agreed. The difference between the contractually agreed price per share and its nominal value is entered into the company's legal reserves account, provided that the legal reserves shall not exceed 50% of the company's issued capital; the remainder will be injected into a special reserves account. The foregoing assumes that EPC-GAFI approval has already been secured. Third, entrepreneurs and investors may agree that it is difficult to go the formal route of the EPC-GAFI, and decide to engage informally, by having investors contribute the amounts corresponding, ratably, to their capital increase shares and those of the founders. This practice avoids a situation where the founders' position would become diluted beyond the equity percentages which would be agreed if they were to go by the EPC-GAFI valuation. The drawbacks to the practice, however, include leaving the investor without a clear paper trail for their total investment in the parts advanced on behalf of the founders.
More difficult for the investor still is that by her/his contribution of the capital increase amounts on behalf of the founders, s/he would have acknowledged on official documents that the founders have paid their pro-rata shares amount, conflicting with any inter partes agreements claiming otherwise. In the end, as well, the formal documents of the company would lack a major record of the company's pre-investment valuation, leaving the corresponding share appreciation achieved in stages prior to the investment unaccounted for and taxable at sales from the nominal to the fair value of the final sale price.

This circumvention, however, is not available to investors in the case of a JSC. In this case, all stock sales need to be executed through a licensed securities broker, and proof of payment needs to be traceable, not merely acknowledged, as in the case of an LLC, although the tax differential between the nominal and the fair value of the final sale price would be paid by the investor.

4.4 Innovative Financing Instruments

The use of convertible notes and their varieties of SAFE, KISS, and ACE, among others, has become popular over the last ten years. When it was brought to the attention of Egyptian regulators, they did not initially approve or disapprove of it. As Egyptian startups began raising funds from international investors, especially the famous Y Combinator and 500 Startups (now rebranded 500 Global), they started using convertibles on the holding entities they incorporated abroad. Other Egyptian startups wanted convertible notes to be made available to Egyptian company structures. At that point, around 2017, the financial regulatory authority (FRA) communicated informally to various ecosystem players that convertibles were subject to securities laws, and that FRA intended to regulate their use. The implicit message was that use of convertible notes on Egyptian company structures was disallowed; and that ecosystem players, specifically startups and their investors, should wait for the model convertible note of the FRA. The informal announcement sent a chill through the ecosystem. Deciding to be safe rather than sorry, ecosystem players refrained from using convertible notes, and abided by the non-officiated FRA position.

Some startups waited dutifully for the model convertible note, which has still not appeared. Others formed their own holding structures in other jurisdictions, offshore and onshore, and received investor funds there. The

situation with the convertible note was not the sole reason for forming holding entities outside Egypt, as other governance and valuations issues discussed earlier pointed in that direction also. Convertible notes simply accelerated the trending practice. It was directly correlated with a startup's ability to fill the quick funding gap, and on terms less onerous than would otherwise be the case.

Five years later, in 2022, the FRA had still not issued a model convertible note. Rather, it issued board Resolution no. 68 for the year 2022, concerning cases for executing transfer of stocks according to shareholder agreements in startup companies. The resolution applies "… to companies and institutions undertaking the activity of venture capital investing into startups through convertible instruments, and where it may accordingly sign shareholders agreements with the startup shareholders, leading to a process of transferring said shares as in the agreement of the parties …." (Financial Regulatory Authority – Board Resolution No. 68 of the Year 2022).

Several comments may be made on this sensitive topic:

(i) First, it is not clear why the FRA took it upon itself to regulate the convertible note, even if it were found to be a security. Convertible notes used to finance startups were popularized predominantly by incubators, accelerators, and angel investors, who wanted to make it easier to fill the quick funding gap most startups suffer from. The convertible note templates came from incubators, accelerators, or angel networks, e.g., the SAFE of the Y Combinator, the KISS of 500 Startups, and others. Neither the Securities and Exchange Commission (SEC) in the USA nor the Netherlands, for example, nor any of the major startup-friendly jurisdiction regulators, issued a model convertible note template. All of the investors using convertible notes are qualified and sophisticated investors, by virtue of their financial worth or professional background. The popular convertible notes confirm qualified investor status and hence the note falls under an exemption from the securities laws.

(ii) No comprehensive study of the viability of convertible notes and their types under Egyptian law seems to have been made by the FRA or by a reputed ecosystem participant.

4.5 Shareholders Agreement

The shareholders agreement is perused for discretion or secrecy, or simply to complement the formal constitutional documents of a company in cases where certain legal institutions are not formally available to shareholders. The hierarchy of the documents is important to investors and investees, with highest priority going to the formal constitutional company documents, as they are fully sanctioned by the state. A main difference to be noted between formal constitutional company documents and shareholders agreements is that, standing on their own, the constitutional company documents are enforceable among their parties and against any third parties, whereas the shareholders agreements are only enforceable among their parties and not against any third parties.

In Egypt, GAFI issues the model constitutional company document templates used for incorporation of companies. As is standard practice with model templates issued by regulators in other jurisdictions, the model templates issued by GAFI are considered

part of the public order, at least in their mandatory sections. Model templates reference different rules of law, mandatory and complimentary. Mandatory rules are incorporated into the articles of the model templates and may not be departed from. Complimentary rules are incorporated into the model templates by way of default, and parties have latitude in changing them. Default rules try to fill open issues in the model templates to allow for their use in transactions. Beyond these issues with the mandatory and default articles, there is the overarching frustration of distinguishing one from the other. At times, the same articles carry features of both. Meanwhile, GAFI employees have exercise discretion and authority in deciding the nature of each article and the extent to which it would be capable of change.

Investors and investees in Egypt's fledgling startup ecosystem have been advised to include all the special deal terms that match their startup investing goals into a shareholders agreement, and they have done that. To guarantee the enforceability of these shareholders agreements, they have been further advised to have the agreements based on laws which will uphold shareholders agreements, rather than terms that go against the letter of law in Egypt, or which have not been tested in court, or have not been elaborated by administrative authorities. This has led to a proliferation of formation of a holding tier abroad to ensure that startup deal terms, privately negotiated and formalized in a shareholders agreement, would be upheld in court, or, even better, be incorporated into the constitutional company documents of the company by way of amendment and restatement. Delaware, the Netherlands, the UAE – Dubai and more recently the ADGM, Singapore, Cayman, and the BVI have provided jurisdictional appeal. Granted, they are not all of the same quality, but they all provide the basic investor-investee incorporation needs and protections in good measure.

As discussed in an earlier section of this report, the Falak and Egypt Ventures experience led their government sponsor, MOIIC, to change the law to allow a startup to attach its shareholders agreement to the company's constitutional documents. MOIC, by doing so, thought to provide a definitive solution to investors and investees, and it was joined by many ecosystem players. The aim was to encourage investments in Egypt rather than other jurisdictions. In 2017, a new paragraph was added to Article 9 of Law no. 159 of the Year 1981 allowing a company to attach its shareholders agreement to its constitutional company documents, provided it procured the approval of 75% of its shareholders base at an extraordinary general meeting. The achievement was short lived, as confusion surrounded the process. By requesting that a shareholders agreement be attached to the constitutional documents of the company, the company's lawyers were advised that the shareholders agreement would be subject to review.

The GAFI staff were split on whether the review was one of form or of substance. It soon became apparent that it would be a review of substance, and that any terms found not in compliance with Egyptian laws would not have effect. The president of GAFI issued an Interpretative Decree to the same effect. This essentially meant that deal terms in the shareholders agreement that mattered the most to investors and investees would not be acknowledged.

4.6 Summary Table

The table below summarizes the issues discussed above.

	Item	Availability JSC	(Y/N) LLC	Comments
1	Preference Shares	Y	N	However, limited in their scope.
	Voting	Y	N	Only at a Ratio of 2:1, and exceptionally more through an arduous process.
	Liquidation	Y	N	
	Dividend	Y	Y	
2	Class of Shares	N	N	Only types of shares is provided.
3	Vesting	N	N	
4	ESOP	Y	N	The process presumes application to companies of magnitude
5	Non-Voting Shares	N	N	
6	Lock-Up	N	N	
7	Drag and Tag Along	N	N	
8	Reserved Matters	N	N	
9	Minority Rights	Y	Y	Limited application compared to investors' needs, hence, of inconsequential effect
10	Ratchet	N	N	

CHAPTER 5
RECOMMENDATIONS

5.1 Introduction

The previous chapters demonstrated the size of the gap between best practices found in a typical startup-friendly jurisdiction and the realities on the ground in Egypt with regard to being attractive to potential startup investors, domestic or international. The nature and the size of this gap were discussed in light of best practices available in more competitive jurisdictions and the present practices in Egypt as related to laws, regulations, legal tools, and other legal considerations.

This chapter provides a preliminary prescription that can help Egypt mend the above-mentioned gap to become an attractive jurisdiction for investors. The recommendations presented in this chapter are divided as follows.

5.2 Agreeing on the Size and the Nature of the Gap

GAFI and the FRA need to be presented with a list of the legal principles required to enable a startup to receive investments at different stages of growth (Appendix 1). The intended outcome is to have their legal teams indicate whether these concepts are available under current Egyptian laws. If available, they will need to address two pivotal questions: (i) what is the extent of their implementation and interpretation, if they are being used? And (ii) what are the relevant rules sanctioning each? If the requisite startup legal concepts are not available, the questions are: (i) would their use conflict with the legal rules available? And (ii) would these be of mandatory or supplementary purport, first, in the laws, and second, in the model company constitutional documents? The result of this exercise would be to coordinate the understandings of GAFI and FRA with those of the entrepreneurship and investment communities.

The above would prevent a situation in which authorities think that corporate law is sufficient for startup-founder-investor structuring purposes and the provision of startup funding, when in fact it is not.

5.3 Review and Amendment of Model Constitutional Company Document Templates

Another exercise to be coordinated with the legal teams of GAFI and FRA is to review the model constitutional document templates in use for company incorporation, to indicate very clearly whether each clause of the template represents a mandatory rule or a supplementary rule. This would provide clarity to founders, investors, and their lawyers on the changes that may be made in the constitutional documents to accommodate startup-founder-investor needs, and also on the extent of the clauses that may be drawn up in a shareholders agreement. As discussed earlier, shareholders agreements may fill gaps not dealt with in the law or included in the constitutional company documents or included in the constitutional documents as default; but in all events they may not privately arrange matters or agreements that contradict the law. Constitutional company document templates are produced by GAFI and the FRA through a delegation in the laws that created both authorities. The templates are then reviewed by the council of state for approval. The legal designation of the templates is advisory.

If GAFI and FRA teams find the law to be a hindrance to startup-founder-investor structuring, a differentiated set of constitutional company document templates may be issued and marked as startup-friendly. They will need to be short and contain only the more critical mandatory rules. The default rules will also need to be few and to allow for easy departure therefrom. Proof of investor qualification - as sophisticated or high net worth individuals - will need to be asserted to avoid systemic risks from allowing startups to tap into retail investor bases who might not be able to accurately appraise the investment opportunity. Qualified investors are presumed to have the necessary expertise and resources to evaluate an investment opportunity presented to them, and to bear the high financial risks associated with startup investing. While a differentiated constitutional company document might serve the needs of the startup-founder-investor dynamic as a whole, it would also guarantee that such investor risks are lessened. Whatever the opportunistic means that might arise, if a constitutional company document can be amended in ways that serve minority shareholders, the provisions established in those documents might help circumvent major issues that minority shareholders (specifically investors) are exposed to constantly because of their minor stake in the company and subsequent impact on corporate decisions. Rather than obtaining safeguards against those issues through private agreements, establishing them in the company's constitutional document would not only help mitigate risks that current minority shareholders face, but also provide them with safeguards and protections that are more enforceable than private agreements.

Agreement templates will need to be produced and periodically updated by reputed incubators and accelerators and angel groups and VC investors associations. Since these entities represent true investment dynamics; the resulting templates will enrich the pool of legal documents available to startup investing. Such enrichment offers users a much-needed variety to choose from or to use as a basis for creating their own, within the bounds of the law, regulations and constitutional company documents. Examples of model legal documents are those of the NVCA, BVCA, and multiple other organizations of international repute. At the local level, the Alex Angels and Cairo Angels agreements will provide useful insights to build upon.

5.4 Affecting Critical Legislative Changes Where Needed

Where GAFI and FRA legal teams find the law to be too restrictive to allow startup-founder-investor structuring through Egyptian-based entities, legislative changes in current mandatory rules of law will need to be developed to provide solutions. Such changes could introduce a simplified Egyptian holding company structure that would simulate international rules and norms in the area. The intended purpose is to create a viable alternative to holdings established in other jurisdictions. Naturally such structure should be capable of holding securities and IP rights in its own subsidiaries in Egypt and/or elsewhere. The simplified holding should also be agile enough to allow for best practices to be fully implemented as they continue to evolve globally. Other national laws should avoid disruption of that holding structure and its rules. The simplified start-up holding may be seen as a supra law in the sphere of its activity. It should benefit from the Egyptian legal norm that private law regimes constrain the parts of the general laws they were issued to replace, expressly or impliedly. The operating subsidiaries would remain subject to the corporate law and all relevant national laws.

5.5 Additional Guarantees and Incentives to Potential Investors

The Egyptian state may consider issuing letters of guarantee for the applicability and interpretation of certain laws and rules of a specific company structure, regardless of future laws that may interfere with the treatment of established companies. Such letters might be provided by GAFI.

As intellectual property often represent the bedrock of technology based or technology enabled startups, heightened awareness, protection, and clarity in implementation to intellectual property rights and licensing agreements could augment investors' belief in Egypt's legal system.

Devising a tax credit scheme to incentivize angels, especially local, to invest in the risky startup asset class, as in the UK, may be a further enticement.

5.6 Special Bank Accounts for Holdings

This can be a low hanging fruit to guarantee capturing of the funds received at the level of the holding company, or part thereof, in Egypt. The Central Bank of Egypt might consider allowing such holding companies (as suggested above) to open a local bank account in Egypt.

5.7 Other Recommendations

There are many other measures that can help address the gap under discussion. For example:

- Forming Forming a Steering Committee from ecosystem stakeholders to support GAFI and FRA efforts to conform to international best practices. The envisaged stakeholders to be recruited to the committee are incubators, accelerators, solo angels, angel syndicates, and early stage and growth VCs.

- Supporting the cause and technical needs of 'Malaikah' as an umbrella organization promoting angels and angel networks.

APPENDIX 1

NON-EXHAUSTIVE LIST OF COMMONLY USED CLAUSES IN STARTUP INVESTMENT AGREEMENTS:

This Appendix contains a non-exhaustive list of the best practice provisions used in investment agreements at Startup funding. Against the inherent defaults of a Startup and the intricate relationship between its investors and founders, these best practice provisions are the culmination of years of negotiations between investors and founders for the sole purpose of achieving the best protections for each's interests in a startup funding deal.

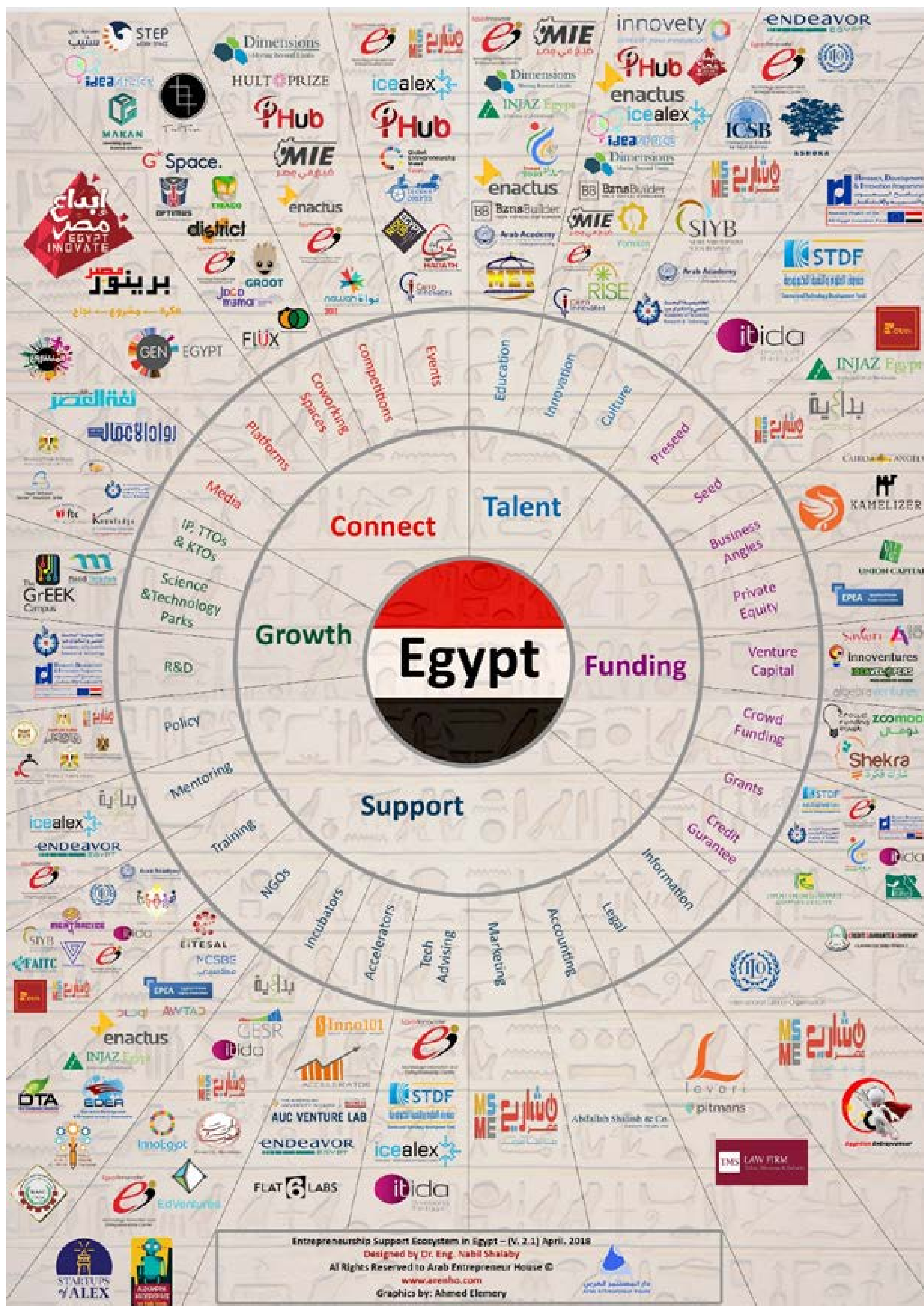
If a jurisdiction's corporate law proves to be limiting or restrictive in nature to the full capacity of those best practices, it would be equivalent to labeling that jurisdiction as unfriendly to Startups; which would subsequently lead to incorporating a holding company tier in a different jurisdiction that promotes and implements those best practices provisions.

The following is a list of best practices provisions:

Best Practice Provisions in Investment Agreements		Best Practice Provisions' Legal Status in the Egyptian Jurisdiction (Y/N)		
		Legality	Enforceability	(*)
1	Preferred Stock/Shares			
2	Classes of Shares; Preferred or Common			
3	Amendable Company Constitutive Document			
4	Voting Provisions Regarding the Board			
5	Right of First Refusal			
6	Right of First Offer			
7	Drag-Along Right			
8	Tag-Along Right			
9	Reserved Matters and Minority Rights			
10	Vesting of Shares			
11	Non-Voting Shares			
12	Liquidation Preference			
13	Voting Preference			
14	ESOP			
15	Lock-Up Period			
16	Pro-Rata and Anti-Dilution provisions			
17	Convertible Preferred Shares			
18	Option Rights			
19	Qualification of Investors			
20	Co-Sale Rights			
21	Dispute Resolution (Including Arbitration)			
22	Pay-To-Play Provision			
23	Information and Observer Rights			
24	Management Rights			
25	Management Commitment Provision			
26	Disclosure and Access of Information			

APPENDIX 2

EGYPT ENTREPRENEURSHIP MAP PRODUCED BY EGYPT-INNOVATE - 2022



Egypt
Connect
Talent
Growth
Funding
Support
Events
Competitions
Coworking Spaces
Platforms
Media
IP, TTOs & KTOs
Science &Technology Parks
R&D
Policy
Mentoring
Training
NGOs
Incubators
Accelerators
Tech Advising
Marketing
Accounting
Legal
Information
Credit Gurantee
Grants
Crowd Funding
Venture Capital
Private Equity
Business Angles
Seed
Preseed
Culture
Innovation
Education
Entrepreneurship Support Ecosystem in Egypt – (V. 2.1) April, 2018
Designed by Dr. Eng. Nabil Shalaby
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POLICY RECOMMENDATIONS TO REVERSE ESTABLISHMENT OF START-UPS AND INVESTMENT VEHICLES OUTSIDE EGYPT

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